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TECHNICAL EXPLANATION OF THE TAX SIMPLIFICATION ACT OF 1991

(H.R. 2777 and S. 1394)

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION
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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the "Tax Simplification of Act of 1991" (H.R. 2777 and S. 1394). H.R. 2777 (Messrs. Rostenkowski and Archer) and S. 1394 (Senators Bentsen and Packwood) were introduced on June 26, 1991.

The Tax Simplification Act of 1991 includes seven titles:

Title I -- Individual Tax Provisions
Title II -- Treatment of Large Partnerships
Title III -- Foreign Provisions
Title IV -- Other Income Tax Provisions
Title V -- Provisions Relating to Estate and Gift Taxation
Title VI -- Excise Tax Provisions
Title VII -- Administrative Provisions

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[1] This document may be cited as follows: *Technical Explanation of the Tax Simplification Act of 1991 (H.R. 2777 and S. 1394)* (JCX-8-91), June 27, 1991.

TECHNICAL EXPLANATION OF THE BILL

Title I.--Individual Tax Provisions

1. Rollover of gain on sale of principal residence (sec. 101 of the bill and sec. 1034 of the Code)

Present Law

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of section 1034.

In general, nonrecognition treatment is available only once during any two-year period. In addition, if the taxpayer purchases more than one residence during the replacement period and such residences are each used as the taxpayer's principal residence within two years after the date of sale of the old residence, only the last residence so used is treated as the new replacement residence.

Special rules apply, however, if residences are sold in order to relocate for employment reasons. First, the number of times nonrecognition treatment is available during a two-year period is not limited. Second, if a residence is sold within two years after the sale of the old residence, the residence sold is treated as the last residence used by the taxpayer and thus as the only replacement residence.

Reasons for Simplification

The rollover provision governing the sale of a principal residence is unnecessarily complex, in part due to the different set of rules that applies depending on whether the sale is work related. The bill simplifies the rollover provision by applying only one set of rules to the sale of a principal residence regardless of whether the sale is work related.

Explanation of Provision

Under the bill, gain is rolled over from one residence to another residence in the order the residences are purchased and used, regardless of the taxpayer's reasons for the sale of the old residence. In addition, gain may be rolled over more than once within a two-year period. Thus, the rules that formerly applied only if a taxpayer sold his residence in order to relocate for employment purposes will apply in all cases.

As under present law, the basis of each succeeding residence is reduced by the amount of gain not recognized on the sale of the prior residence.

Effective Date

The provision applies to sales of old residences (within the meaning of section 1034) after the date of enactment.

2. Due dates for estimated tax payments of individuals (sec. 102 of the bill and sec. 6654 of the Code)

Present Law

In order to avoid an addition to tax, estimated tax payments of individuals generally are due on April 15th, June 15th, and September 15th of the taxable year for which the payment relates, and January 15th of the following taxable year. The amount of the estimated tax payments generally must be based on 90 percent of the tax shown on the return for the taxable year or 100 percent of the tax shown on the return for the preceding taxable year.

The due date for the tax return of an individual generally is April 15th of year following the taxable year to which the return relates. The due date may be automatically extended to August 15th.

Reason for Simplification

Delaying the due date of the second estimated tax installment would allow for a more accurate determination of the amount of the required payment if the payment is based on the tax shown on the return for the current year or if the payment is based on the tax shown on the return for the preceding year and the due date of the return for the preceding year has been extended.

Explanation of Provision

Under the bill, the due date for the second estimated tax payment of individuals is July 15th of the taxable year for which the payment relates.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

3. Permit payment of taxes by credit card (sec. 103 of the bill and sec. 6311 of the Code)

Present Law

Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by regulations.

Reasons for Simplification

Credit cards are a commonly used and reliable form of payment. Some taxpayers may find paying taxes by credit card more convenient than paying by check or money order.

Explanation of Provision

The bill permits payment of taxes by credit card, to the extent and under the conditions provided by regulations.

Effective Date

The provision is effective on the date of enactment.

4. Election by parent to claim unearned income of certain children on parent's return (sec. 104 of the bill and secs. 1(g)(7) and 57(j)(1) of the Code)

Present Law

The net unearned income of a child under 14 years of age is taxed to the child at the top rate of the parents. Net unearned income means unearned income less the sum of $500 and the greater of: (1) $500 of the standard deduction or $500 of itemized deductions or (2) the amount of allowable deductions directly connected with the production of the unearned income. The dollar amounts are adjusted for inflation.

In certain circumstances, a parent may elect to include a child's unearned income on the parent's income tax return if the child's income is less than $5,000. A parent making this election must include the gross income of the child in excess of $1,000 in income for the taxable year. In addition, the parent must report an additional tax liability equal to the lesser of (1) $75 or (2) 15 percent of the excess of the child's income over $500. The dollar amounts for the election are not adjusted for inflation.

A person claimed as a dependant cannot claim a standard deduction exceeding the greater of $500 or such person's earned income. For alternative minimum tax purposes, the exemption of a child under 14 years of age generally cannot exceed the sum of such child's earned income plus $1,000. The $500 amount is adjusted for inflation but the $1,000 amount is not.

Reasons for Simplification

The election by a parent to include a child's unearned income on a return is intended to eliminate the need to file a separate return for a child without reducing the family's total tax liability. Indexation of the underlying dollar amounts simplifies return preparation by making the election available to more taxpayers.

The restriction upon the exemption allowed to a child for alternative minimum tax purposes is intended to treat the family the same as if the child's income had been included on the parent's return. Indexation of this exemption amount achieves this goal and simplifies transfers by removing a tax consideration influencing the ownership of property within the family.

Explanation of Provision

The bill adjusts for inflation the dollar amounts involved in the election to claim unearned income on the parent's return. It likewise indexes the $1,000 amount used in computing the child's alternative minimum tax.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

5. Simplified foreign tax credit limitation for individuals (sec. 105 of the bill and sec. 904 of the Code)

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income, and foreign taxes paid, in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments (e.g., dividends from a foreign corporation subject to foreign withholding taxes, or dividends from a domestic mutual fund that can pass through its foreign taxes to the shareholder (see sec. 853)). Taxable income of this type ordinarily is subject to the single foreign tax credit limitation category known as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in several other separate limitation categories (e.g., high withholding tax interest income, general limitation income) designed to accomplish certain policy objectives or forestall certain abuses. For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Reasons for Simplification

It is believed that a significant number of individuals are entitled to credit relatively small amounts of foreign tax, imposed at modest effective tax rates on foreign source investment income. For taxpayers in this class, it is believed that applicable foreign tax credit limitations typically exceed the amounts of taxes paid. Therefore, it is believed that relieving these taxpayers from application of the full panopoly of foreign tax credit rules may achieve significant reduction in the complexity of the tax law without significantly altering actual tax liabilities. At the same time, however, it is believed that the benefits of simplified treatment should be limited to cover those cases where the taxpayer is receiving a payee statement showing the amount of the foreign source income and the foreign tax.

Explanation of Provision

The bill allows individuals with no more than $200 of creditable foreign taxes, and no foreign source income other than income which is in the passive basket, to elect a simplified foreign tax credit limitation equal to the lesser of 25 percent of the individual's foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year. (It is intended that an individual electing this simplified limitation calculation not be required to file Form 1116 in order to obtain the benefit of the credit.) A person who elects the simplified foreign tax credit limitation is not allowed a credit for any foreign tax not shown on a payee statement (as that term is defined in sec. 6724(d)(2)) furnished to him or her. Nor is the person entitled to treat any excess credits for a taxable year to which the election applied as a carryover to another taxable year. Because the limitation for a taxable year to which the election applies can be no more than the creditable foreign taxes actually paid for the taxable year, it is also the case under the bill that no excess credits from another year can be carried over to the taxable year to which the election applies.

For purposes of the simplified limitation, passive income generally is defined to include all types of income that would be foreign personal holding income under the subpart F rules, plus income inclusions from passive foreign corporations (as defined above by the bill), so long as the income is shown on a payee statement furnished to the individual. Thus, for purposes of the simplified limitation, passive income includes all dividends, interest (and income equivalent to interest), royalties, rents, and annuities, and net gains from dispositions of property giving rise to such income, from certain commodities transactions, and from foreign currency transactions that give rise to foreign currency gains and losses as defined in section 988. The statutory exceptions to treating these types of income as passive for foreign tax credit limitation purposes, such as the exceptions for high-taxed income and high withholding tax interest, are not applicable in determining eligibility to use the simplified limitation.

Although an estate or trust generally computes taxable income and credits in the same manner as in the case of an individual (Code sec. 641(b); Treas. Reg. sec. 1.641(b)-1), the simplified limitation does not apply to an estate or trust.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

6. Personal transactions by individuals in foreign currency (sec. 106 of the bill and sec. 988 of the Code)

Present Law

When a U.S. taxpayer with a dollar functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use--while traveling abroad--realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 (the "1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application were provided by Treasury regulations and, in a few instances, statutory provisions. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The result of prior law was uncertainty of tax treatment for many legitimate transactions, as well as opportunities for tax-motivated transactions. Therefore, in 1986 Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving "nonfunctional currencies;" that is, currencies other than the taxpayer's "functional currency."

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.[1]

Reasons for Simplification

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to ordinary daily life. Instead, the local currency must often be used, yet the individual will not be treated for tax purposes as having changed his or her functional currency to the local currency. If it were necessary to treat foreign currency in this instance as property giving rise to U.S. dollar income or loss every time it was, in effect, "bartered" for goods or services, the U.S. individual living in or visiting a foreign country would have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. An analogous issue arises for a corporation that has a qualified business unit ("QBU") in a foreign country but nevertheless uses the U.S. dollar as its functional currency pursuant to section 986(b)(3). Complexity concerns aside, Congress could have required in that case that gain or loss be computed on each transaction carried out in the local currency. Instead, however, Congress directed the Treasury to adopt a method of translation of the QBU's results that merely approximates the results of determining exchange gain or loss on a transaction-by-transaction basis.[2] It is believed that individuals also should be given relief from the requirement to keep track of gains on an actual transaction-by-transaction basis in certain cases.

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[1] See, e.g., Rev. Rul. 90-79, 1990-2 C.B. 26 (where the taxpayer purchased a house in a foreign country, financed by a foreign currency loan, and the currency appreciates before the house is sold and the loan is repaid, the taxpayer's exchange loss on repayment of the loan is not deductible under sec. 988 and does not offset taxable gain on the sale of the house).

Explanation of Provision

In a case where an individual acquires nonfunctional currency and then disposes of it in a personal transaction, and where exchange rates have changed in the intervening period, the bill provides for nonrecognition of an individual's resulting exchange gains not exceeding $200. The bill does not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

7. Advance due date for furnishing information to partners (sec. 107 of the bill and sec. 6031(b) of the Code)

Present Law

A partnership required to file an income tax return with the IRS must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships).

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[2] See Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 at 1096 (1987); Treas. Reg. sec. 1.985-3.

This is the same deadline by which most individual partners must file their tax returns.

Reasons for Simplification

Information returns that are received on or shortly before April 15 (or later) are difficult for individuals to use in preparing their tax returns (or in computing their payments) that are due on that date.

Explanation of Provision

The bill provides that a large partnership must furnish information returns to partners by the 15th day of the 3d month following the close of the partnership's taxable year. A large partnership is any partnership with 250 or more partners, as well as any partnership subject to the simplified reporting rules for large partnerships (contained in sec. 201 of this bill, described below).

Effective Date

The provision is effective for taxable years ending on or after December 31, 1992.

8. Make income tax withholding rules parallel to rules for exclusion from income for combat pay (sec. 108 of the bill and sec. 3401(a)(1) of the Code)

Present Law

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income (special rules apply if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone). In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding

There is no income tax withholding with respect to military pay for a month in which a member of the Armed Forces of the United States is entitled to the benefits of section 112 (sec. 3401(a)(2)). With respect to enlisted personnel, this income tax withholding rule parallels the exclusion from income under section 112: there is total exemption from income tax withholding and total exclusion from income. With respect to officers, however, the withholding rule is not parallel: there is total exemption from income tax withholding, although the exclusion from income is limited to $500 per month.

Reasons for Simplification

In most instances, the wage withholding rules closely parallel the inclusion in income rules. Consequently, most individuals whose income is subject to withholding may rely on withholding to fulfill their tax obligations. The differences between the withholding rules and the exclusion rules with respect to combat pay could cause affected taxpayers (primarily officers) to be surprised at the size of their additional tax liability at the time of filing their tax returns as a result of underwithholding. Paying the additional tax liability with their tax returns could lead to greater financial hardship than would withholding that is parallel to the exclusion rules.

Explanation of Provision

The bill makes the income tax withholding exemption rules parallel to the rules providing an exclusion from income for combat pay.

Effective Date

The provision is effective as of January 1, 1992.

9. Expanded access to simplified income tax returns (sec. 109 of the bill)

Present Law

There are three principal tax forms that are utilized by individual taxpayers: Form 1040EZ, Form 1040A, and Form 1040.

Reasons for Simplification

Many individual taxpayers find the tax forms to be complex.

Explanation of Provision

The bill provides that the Secretary of the Treasury (or his delegate) shall take such actions as may be appropriate to expand access to simplified individual income tax forms and to otherwise simplify the individual income tax returns.

The bill also requires that the Secretary submit a report to the Congress on the actions undertaken pursuant to this provision, together with any recommendations he may deem advisable.

Effective Date

The report is due no later than one year after the date of enactment.

10. Simplification of tax treatment of rural letter carriers' vehicle expenses (sec. 110 of the bill and sec. 162 of the Code)

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). If the taxpayer is an employee and these expenses are not reimbursed, the deduction is subject to the two-percent floor. Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes, and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his or her deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150 percent of the standard mileage rate.

Reasons for Simplification

The filing of tax returns by rural letter carriers can be complex. Under present law, those who are reimbursed at more than the 150 percent rate must report their reimbursement as income, and deduct their expenses as miscellaneous itemized deductions (subject to the 2 percent floor). Permitting the income and expenses to wash, so that neither will have to be reported on the rural letter carrier's tax return, will simplify these tax returns.

Explanation of Provision

The bill repeals the special rate of 150 percent of the standard mileage rate. In its place, the bill provides that the rate of reimbursement provided by the Postal Service to rural letter carriers is considered to be equivalent to their expenses. The rate of reimbursement that is considered to be equivalent to their expenses is the current rate of reimbursement contained in the 1991 collective bargaining agreement, which may in the future be increased by no more than the rate of inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

11. Exemption from luxury excise tax for certain equipment installed on passenger vehicles for use by disabled individuals (sec. 111 of the bill and sec. 4004(b)(3) of the Code)

Present Law

The Code imposes a 10-percent excise tax on the portion of the retail price of a passenger vehicle that exceeds $30,000. The tax also applies to separate purchases of component parts and accessories occurring within six months of the date the vehicle is placed in service.

Reasons for Simplification

It is appropriate to reduce the compliance burdens on handicapped persons.

Explanation of Provision

The bill provides that the luxury excise tax does not apply to a part or accessory installed on a passenger vehicle to enable or assist an individual with a disability to operate the vehicle, or to enter or exit the vehicle, by compensating for the effect of the disability.

Effective Date

The provision is effective for purchases after December 31, 1990.

Title II.--Treatment of Large Partnerships

A. General Provisions

1. Simplified flow-through for large partnerships (sec. 201 of the bill and new secs. 771-777 of the Code)

Present Law

Treatment of partnerships in general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Capital gains

The net capital gain of an individual is taxed generally at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent. Net capital gain is the excess of net long-term capital gain over net short-term capital loss. Individuals with a net capital loss generally may deduct up to $3,000 of the loss each year against ordinary income. Net capital losses in excess of the $3,000 limit may be carried forward indefinitely.

A special rule applies to gains and losses on the sale, exchange or involuntary conversion of certain trade or business assets (sec. 1231). In general, net gains from such assets are treated as long-term capital gains but net losses are treated as ordinary losses.

A partner's share of a partnership's net short-term capital gain or loss and net long-term capital gain or loss from portfolio investments is separately reported to the partner. A partner's share of a partnership's net gain or loss under section 1231 generally is also separately reported to the partner.

Deductions

Miscellaneous itemized deductions (e.g., certain investment expenses) are deductible as an itemized deduction, but only to the extent that, in the aggregate, they exceed two percent of the individual's adjusted gross income.

In general, taxpayers are allowed a deduction for charitable contributions, subject to certain limitations. In the case of an individual, the deduction cannot exceed 50 percent of the individual's contribution base (generally, the individual's adjusted gross income) for the taxable year. In the case of a corporation, the deduction cannot exceed 10 percent of the corporation's taxable income (computed with certain modifications). Excess contributions are carried forward for five years.

A partner's distributive share of a partnership's miscellaneous itemized deductions and charitable contributions are separately reported to the partner.

Credits in general

Each partner is allowed his distributive share of credits against his taxable income. A refundable credit for gasoline used for exempt purposes is allowed. Nonrefundable credits for clinical testing expenses for certain drugs for rare diseases, for producing fuel from nonconventional sources, and for the general business credit are also allowed. The general business credit includes the investment credit (which in turn includes the rehabilitation credit), the targeted jobs credit, the alcohol fuels credit, the research credit, and the low-income housing credit.

The credits for clinical testing expenses and for fuel from nonconventional sources are limited to the excess of regular tax over tentative minimum tax. Excess credits generally cannot be carried forward. The amount of general business credit allowable in a taxable year is limited to the excess of a partner's net income over the greater of (1) the tentative minimum tax for the year or (2) 25 percent of the taxpayer's net regular tax liability in excess of $25,000. The general business credit in excess of this amount is carried back three years and forward 15 years.

The benefit of the investment credit and the low-income housing credit is recaptured if, within a specified time period, the partner transfers his partnership interest or the partnership converts or transfers the property for which the credit was allowed.

Foreign tax credit

The foreign tax credit generally allows U.S. taxpayers to reduce U.S. income tax on foreign income by the amount of foreign income taxes paid with respect to that income. In lieu of electing the foreign tax credit, a taxpayer may deduct foreign taxes from adjusted gross income.

The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." That is, the total amount of the credit for foreign taxes on income in each category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income in that category bears to the taxpayer's worldwide taxable income for the taxable year. A partner generally reports his share of partnership income from each category. A special rule, however, treats the distributive share of a limited partner owning less than ten percent of a partnership as *per se* in the passive category.

The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation may be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years and credited to the extent that the taxpayer otherwise has excess foreign tax credit limitations for the appropriate separate limitation category for those years.

Unrelated business taxable income

Tax-exempt organizations are subject to tax on income from unrelated businesses. Certain types of income (such as dividends, interest and certain rental income) are not treated as unrelated business taxable income. Thus, for a partner that is an exempt organization, whether partnership income is unrelated business taxable income depends on the character of the underlying income. Income from a publicly traded partnership, however, is treated as unrelated business taxable income regardless of the character of the underlying income.

Passive losses

The passive loss rules generally disallow deductions and credits from passive activities to the extent they exceed income from passive activities. Losses not allowed in a taxable year are suspended and treated as current deductions from passive activities in the next taxable year. These losses are allowed in full when a taxpayer disposes of the entire interest in the passive activity to an unrelated person in a taxable transaction. Passive activities include trade or business activities in which the taxpayer does not materially participate. (Limited partners generally do not materially participate in the activities of a partnership.) Passive activities also include rental activities (regardless of the taxpayer's material participation).[3] Portfolio income (such as interest and dividends), and expenses allocable to such income, are not treated as income or loss from a passive activity.

A partnership's operations may be treated as multiple activities for purposes of the passive loss rules. In such case, the partnership must separately report items of income and deductions from each of its activities.

Income from a publicly traded partnership is treated as portfolio income under the passive loss rules. In addition, loss from such a partnership is treated as separate from income and loss from any other publicly traded partnership, and also as separate from any income or loss from passive activities.

REMICs

A tax is imposed on partnerships holding a residual interest in a real estate mortgage investment conduit (REMIC). The amount of the tax is the amount of excess inclusions allocable to partnership interests owned by certain tax-exempt organizations ("disqualified organizations") multiplied by the highest corporate tax rate.

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[3] An individual who actively participates in a rental real estate activity and holds at least a 10 percent interest may deduct up to $25,000 of passive losses. The $25,000 amount phases out as the individual's income increases from $100,000 to $150,000.

The $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the income phaseout range for the $25,000 allowance for these credits is $200,000 to $250,000 (rather than $100,000 to $150,000). For interests acquired after December 31, 1989 in partnerships holding property placed in service after that date, the $25,000 deduction-equivalent allowance is permitted for the low-income housing credit without regard to the taxpayer's income.

Contribution of property to a partnership

In general, a partner recognizes no gain or loss upon the contribution of property to a partnership. However, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be allocated among the partners so as to take into account the difference between the basis of the property to the partnership and its fair market value at the time of contribution. In addition, the contributing partner must recognize gain or loss equal to such difference if the property is distributed to another partner within five years of its contribution (sec. 704(c)). Under regulations, the amount of depreciation and gain or loss that is allocated under these rules is limited to the depreciation allowable to, or gain or loss recognized by, the partnership for tax purposes with respect to the contributed property (the "ceiling rule").

Election of optional basis adjustments

In general, the transfer of a partnership interest or a distribution of partnership property does not affect the basis of partnership assets. A partnership, however, may elect to make certain adjustments in the basis of partnership property (sec. 754). Under a section 754 election, the transfer of a partnership interest generally results in an adjustment in the partnership's basis in its property for the benefit of the transferee partner only, to reflect the difference between that partner's basis for his interest and his proportionate share of the adjusted basis of partnership property (sec. 743(b)). Also under the election, a distribution of property to a partner in certain cases results in an adjustment in the basis of other partnership property (sec. 734(b)).

Terminations

A partnership terminates if either (1) all partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50 percent or more of the total partnership interests are sold or exchanged (sec. 708).

Reasons for Simplification

The requirement that each partner take into account separately his distributive share of a partnership's items of income, gain, loss, deduction and credit can result in the reporting of a large number of items to each partner. The Schedule K-1, on which such items are reported, contains space for more than 40 items. Reporting so many separately stated items is burdensome for individual investors with relatively small, passive interests in large partnerships. In many respects such investments are indistinguishable from those made in corporate stock or mutual funds, which do not require reporting of numerous separate items.

In addition, the number of items reported under the current regime makes it difficult for the Internal Revenue Service to match items reported on the K-1 against the partner's income tax return. Matching is also difficult because items on the K-1 are often modified or limited at the partner level before appearing on the partner's tax return.

By significantly reducing the number of items that must be separately reported to partners, the provision eases the reporting burden of partners and facilitates matching by the IRS. Moreover, it is understood that the Internal Revenue Service is considering restricting the use of substitute reporting forms by large partnerships. Reduction of the number of items makes possible a short standardized form.

In addition, the rules governing allocations with respect to property contributed to a partnership and the rules regarding partnership terminations are ill-suited to large partnerships, whose interests are commonly transferred. By adopting a deferred sale approach for property contributions and by reducing the possibility of partnership terminations, the provision improves the administration of the tax rules governing large partnerships.

Explanation of Provisions

In general

The bill modifies the tax treatment of a large partnership (generally, a partnership with at least 250 partners) and its partners. The bill provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain to the extent allocable to passive loss limitation activities and other activities; (4) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (5) general credits; (6) low-income housing credit; (7) rehabilitation credit; (8) for certain partnerships, tax-exempt interest; and (9) for certain partnerships, foreign taxes paid and foreign source partnership items.[4]

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[4] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income are applied separately with respect to that partner by taking

(Footnote continued)

Under the bill, the taxable income of a large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifications are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions.[5] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and section 68 itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level. Thus, for example, any investment interest of the partnership is limited at the partnership level, and any carryover is made at that level.

All elections affecting the computation of taxable income or any credit are made by the partnership.

Capital gains

Under the bill, netting of capital gains and losses occurs at the partnership level. A partner in a large partnership takes into account separately his distributive share of the partnership's net capital gain.[6] Any excess of capital losses over capital gains, however, is not separately reported to partners; rather, such excess is carried over at the partnership level. The partnership cannot offset any portion of capital losses against ordinary income.

A partner's distributive share of the partnership's net capital gain is allocated between passive loss limitation activities and other activities. The net capital gain is allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities, and any excess is allocated to other activities.

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[4] (continued)
into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

[5] A large partnership is allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance, as described below.

[6] Any excess of net short-term capital gain over net long-term capital loss is consolidated with the partnership's other taxable income and is not separately reported.

Any gains and losses of the partnership under section 1231 are netted at the partnership level. Net gain is treated as long-term capital gain and is subject to the rules described above. Net loss is treated as ordinary loss and consolidated with the partnership's other taxable income.

Deductions

The bill contains two special rules for deductions. First, miscellaneous itemized deductions are not separately reported to partners. Instead, 70 percent of the amount of such deductions is disallowed at the partnership level;[7] the remaining 30 percent is allowed at the partnership level in determining taxable income, and is not subject to the two-percent floor at the partner level.

Second, charitable contributions are not separately reported to partners under the bill. Instead, the charitable contribution deduction is allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

Credits in general

Under the bill, general credits are separately reported to partners as a single item. General credits are any credits other than the low-income housing credit and the rehabilitation credit. A partner's distributive share of general credits is taken into account as a current year general business credit. Thus, for example, the credits for clinical testing expenses and the production of fuel from nonconventional sources are subject to the present law limitations on the general business credit. The refundable credit for gasoline used for exempt purposes is allowed to the partnership, and thus is not separately reported to partners.

In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits are separately reported.[8]

The bill imposes credit recapture at the partnership level and determines the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. Under the bill, the transfer of an interest in a large partnership does not trigger recapture.

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[7] The "70 percent" figure is intended to approximate the amount of such deductions that would be denied at the partner level as a result of the two-percent floor.

Foreign tax credit

Elections, computations and limitations regarding the foreign tax credit generally are made at the partnership level without regard to a partner's other foreign source income or foreign taxes paid. For purposes of determining foreign tax credit limitations, the partnership is treated as an individual subject to tax at a 25-percent rate. Excess credits can be carried forward at the partnership level but cannot be carried back. The foreign tax credit is reported to the partner as a general credit. The partner's distributive share of all items of income, gain, loss or deduction are treated as derived from sources within the United States.

A different rule applies if either the partnership elects, or 25 percent or more of the gross income of the partnership is derived from sources outside the United States. In such case, elections, computations and limitations are made by the partner, as under present law. The partnership reports to the partner creditable foreign taxes and the source of any income, gain, loss or deduction taken into account by the partnership. As under present law, such income is generally treated as passive for separate limitation purposes.

Tax-exempt interest

Under the bill, interest on a State or local bond is treated as taxable (and thus not separately reported) unless at the end of each quarter of the taxable year at least 50 percent of the value of partnership assets consists of State or local bonds the interest on which is exempt from taxation.

Unrelated business taxable income

The bill retains present-law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items is taken into account separately to the extent necessary to comply with the rules governing such income. Under the bill, all income from a publicly traded partnership continues to be treated as unrelated business taxable income.

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[8] It is intended that the rehabilitation and low-income housing credits which are subject to the same passive loss rules (i.e., in the case of the low-income housing credit, where the partnership interest was acquired or the property was placed in service before 1990) could be reported together on the same line.

Passive losses

Under the bill, a partner in a large partnership takes into account separately his distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term "passive loss limitation activity" means any activity which involves the conduct of a trade or business (including any activity treated as a trade or business under sec. 469(c)(5) or (6)) and any rental activity. A partner's share of a large partnership's taxable income or loss from passive loss limitation activities is treated as an item of income or loss from the conduct of a trade or business which is a single passive activity, as defined in the passive loss rules. Thus, a large partnership is not required to separately report items from multiple activities.

A partner in a large partnership also takes into account separately his distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense.

Under the bill, income from a publicly traded partnership continues to be treated as portfolio income.

Alternative minimum tax

Under the bill, alternative minimum tax adjustments and preferences are combined at the partnership level. A large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's alternative minimum taxable income, a partner's distributive share of any net AMT adjustment is taken into account instead of making separate AMT adjustments with respect to partnership items. Except as provided in regulations, the net AMT adjustment is determined by using the adjustments applicable to individuals, and is treated as a deferral preference for purposes of the section 53 minimum tax credit.

REMICs

For purposes of the tax on partnerships holding residual interests in REMICs, all interests in a large partnership are treated as held by disqualified organizations. Thus, a large partnership holding a residual interest in a REMIC is subject to a tax equal to the excess inclusions multiplied by the highest corporate rate.

Deferred sale treatment for contributed property

In general

For all partners contributing property to a large partnership (including partners otherwise excluded from application of the large partnership rules, as described below), the bill replaces section 704(c) with a "deferred sale" approach. Under the bill, a large partnership is treated as if it had purchased the property from the contributing partner for its then fair market value, thus taking a fair market value basis in the property. The contributing partner's gain or loss on the contribution (the "precontribution gain or loss")[9] is deferred until the occurrence of specified recognition events. In general, the character of the precontribution gain or loss is the same as if the property had been sold to the partnership by the partner at the time of contribution. The contributing partner's basis in his partnership interest is adjusted for precontribution amounts recognized under the provision. These adjustments generally are made immediately before the recognition event.

The provision effectively repeals the ceiling rule for large partnerships, i.e., the amount of precontribution gain or loss recognized by the contributing partner under the provision is not limited to the overall gain or loss from the contributed property recognized by the partnership. In addition, the amount of depreciation allowable to the partnership is not limited to the contributing partner's basis in the property.

Recognition events

Certain events occurring at either the partnership or partner level cause recognition of precontribution gain or loss. Loss is not recognized, however, by reason of a disposition to a person related (within the meaning of sec. 267(b)) to the contributing partner.

Transactions at partnership level.--The contributing partner recognizes precontribution gain or loss as the partnership claims an amortization, depreciation, or depletion deduction with respect to the property. The amount of gain (or loss) recognized equals the increase (or decrease) in the deduction attributable to changes in basis of the property occurring by reason of its contribution. Any gain or loss so recognized is treated as ordinary.

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[9] Precontribution gain is the excess of the fair market value of the contributed property at the time of contribution over the adjusted basis of such property immediately before such contribution. Precontribution loss is the excess of the adjusted basis of such property over its fair market value.

The contributing partner also recognizes precontribution gain or loss if the partnership disposes of the contributed property to a person other than the contributing partner. If such property is distributed to the contributing partner, its basis in the hands of the contributing partner equals its basis immediately before the contribution, adjusted for any gain or loss previously recognized on account of the deferred sale. No adjustment is made to the basis of undistributed partnership property on account of a distribution to the contributing partner.[10]

Transactions at partner level.--A contributing partner recognizes precontribution gain or loss to the extent that he disposes of his partnership interest other than at death.[11] Such partner also recognizes precontribution gain or loss to the extent that the cash and fair market value of property (other than the contributed property) distributed to him exceeds the adjusted basis of his partnership interest immediately before the distribution (determined without regard to any basis adjustment under the deemed sale rules resulting from the distribution).

Election of optional basis adjustments

Under the bill, a large partnership may still elect to adjust the basis of partnership assets with respect to transferee partners. The computation of a large partnership's taxable income is made without regard to the section 743(b) adjustment. As under present law, the section 743(b) adjustment is made only with respect to the transferee partner. In addition, a large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner, as under present law.

Terminations

The bill provides that a large partnership does not terminate for tax purposes solely because 50 percent of its interests are sold or exchanged within a 12-month period.

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[10] Amounts recognized by reason of these recognition events are taken into account in the partner's taxable year in which or with which ends the partnership taxable year of the deduction or disposition.

[11] It is intended that a deceased partner's successor in interest would not recognize any remaining precontribution gain or loss.

Partnerships and partners subject to large partnership rules

Definition of large partnership

A "large partnership" is any partnership if the number of persons who were partners in such partnership in a taxable year was at least 250.[12] Any partnership treated as a large partnership for a taxable year is so treated for all succeeding years, even if the number of partners falls below 250. Regulations may provide, however, that if the number of persons who are partners in any taxable year falls below 100, the partnership is not treated as a large partnership. Partnerships with at least 100 partners can elect to be treated as if they had 250 partners. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

A large partnership does not include any partnership if substantially all of its activities involve the performance of personal services by individuals owning, directly or indirectly, interests in the partnership, or if 50 percent or more of the value of the partnership's assets consists of oil or gas properties.

Treatment of excluded partners

In general, the large partnership rules do not apply to an excluded partner's distributive share of partnership items. An excluded partner is any partner (1) owning more than a five percent partnership interest at any time during the taxable year, or (2) materially participating in the partnership's activities during the year and holding any interest which is not a limited partnership interest. Any partner treated as an excluded partner for a taxable year is so treated for all succeeding years. In determining whether a partner is an excluded partner, the treatment on the large partnership's tax return binds the partnership and the partner, but not the Secretary.

Treatment of partnerships holding oil or gas properties

As described above, the large partnership rules do not apply to a partnership if at least 50 percent of the value of its assets consists of oil or gas properties.[13] In addition, the rules do not apply to any item attributable to any partnership oil or gas property. However, oil or gas partnerships can elect to be treated as large partnerships. In addition, partnerships owning oil or gas properties but which otherwise qualify as large partnerships (i.e., because less than 50 percent of their assets consists of oil or gas properties) can elect to apply the large partnership rules to items attributable to their oil or gas properties. If either type of partnership makes an election, (1) depletion is computed without regard to percentage depletion, (2) any partner who is an integrated oil company is treated as an excluded partner, and (3) any partner who holds a working interest in an oil or gas property (either directly or through an entity which does not limit the partner's liability) is treated as an excluded partner with respect to such interest. The election applies to the year for which made and all subsequent years, and cannot be revoked without the Secretary's consent.

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[12] The number of partners is determined by counting only persons directly holding partnership interests in the taxable year; persons holding indirectly (e.g., through another partnership) are not counted. It is not necessary for a partnership to have 250 or more partners at any one time in a taxable year for the partnership to constitute a large partnership.

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of the provisions.

Effective Date

The provisions generally apply to partnership taxable years ending on or after December 31, 1992. The deferred sale provision applies to any contribution of property (other than cash) made on or after January 1, 1992, to a partnership which is, or is reasonably expected to become, a large partnership.

2. Simplified audit procedures for large partnerships (sec. 202 of the bill and secs. 6240, 6241, 6242, 6245, 6246, 6247, 6249, 6251, 6252, 6255, and 6256 of the Code)

Present Law

In general

Prior to 1982, a partnership (regardless of its size) was audited only by auditing each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the

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[13] For this purpose, oil or gas properties means the mineral interests in oil or gas which are of a character with respect to which a deduction for depletion is allowable under section 611.

partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the determination of all "partnership items" at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Administrative proceedings

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to partners whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Reasons for Simplification

Present audit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located (some may no longer be partners). In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually.

Explanation of Provision

In general

The bill creates a new audit system for large partnerships. The bill defines "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners) except that certain oil and gas partnerships are large partnerships for the audit rules that are not subject to the large partnership reporting requirements.[14]

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[14] The bill also excludes from the audit provisions partners who are excluded from the reporting rules. Such a partner who is excluded from the audit rules, however, is excluded only to the extent his or her interest in the partnership in the year in which an adjustment took effect does not exceed his or her interest in the partnership taxable year to which the adjustment related.

As under present law, large partnerships and their partners are subjected to unified audit rules. Partnership items are determined at the partnership, rather than the partner, level. The term "partnership items" is defined as under present law.

Unlike present law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners will adjust their current-year share of partnership items of income, gains, losses, deductions, or credits to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest individual or corporate tax rate. A partner may not file a claim for credit or refund of his allocable share of the payment.

Regardless of whether a partnership adjustment flows through to the partners, an adjustment must be offset if it requires another adjustment in a year after the adjusted year and before the year the offsetted adjustment takes effect. For example, if a partnership expensed a $1,000 item in year 1, and it was determined in year 4 that the item should have been capitalized and amortized ratably over 10 years, the adjustment in year 4 would be $600, apart from any interest or penalty. (The $1,000 adjustment for the improper deduction is offset by $400 of adjustments for amortization deductions.) The year 4 partners would be required ratably to include an additional $600 in income for that year.

In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership would be liable for 4 years worth of interest (on a declining principal amount).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to the extent necessary to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Administrative proceedings

Under the large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS could treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner.

As under present law, the IRS could challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike present law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership representative

The bill requires each large partnership to designate a partner or other person to act on its behalf. If a large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS' designation, a large partnership could still designate a replacement for the IRS-designated partner.

Notice requirements

Unlike present law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of disputes concerning partnership items

As under present law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally could not adjust a partnership item of a large partnership more than 3 years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect (secs. 6248, 6501 and 6502).

Effective Date

The provision applies to partnership taxable years ending on or after December 31, 1992.

3. Partnership returns on magnetic media (sec. 203 of the bill and sec. 6011 of the Code)

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Reasons for Simplification

Most entities that file large numbers of documents with the Internal Revenue Service must do so on magnetic media. Conforming the reporting provisions for large partnerships to the generally applicable information reporting rules will facilitate integration of partnership information into already existing data systems.

Explanation of Provision

The bill authorizes the Internal Revenue Service to require large partnerships, and other partnerships with 250 or more partners, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Effective Date

The provision applies to partnership taxable years ending on or after December 31, 1992.

B. Partnership Proceedings Under TEFRA[15]

1. Clarify the treatment of partnership items in deficiency proceedings (sec. 211 of the bill and sec. 6234 of the Code)

Present Law

TEFRA partnership proceedings must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in Munro v. Commissioner, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in Munro, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Reasons for Simplification

The opinion in Munro creates problems for both taxpayers and the IRS. For example, a taxpayer would be harmed in the case where he has invested in a TEFRA partnership and is also subject to the deficiency procedures with respect to nonpartnership item adjustments, since computing the tax liability without regard to partnership items will have the same effect as if the partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceeding is completed, the taxpayer is ultimately allowed any part of the losses, the taxpayer will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the taxpayer will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, a taxpayer in such a case would be deprived of a prepayment forum with respect to the partnership item adjustments. The IRS would be harmed if a taxpayer's income is primarily from a TEFRA partnership, since the IRS may be unable to adjust nonpartnership items such as medical expense deductions, home mortgage interest deductions or charitable contribution deductions because there would be no deficiency since, under Munro, the income must be ignored.

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[15] Tax Equity and Fiscal Responsibility Act of 1982.

Explanation of Provision

The bill is intended to overrule Munro and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This will eliminate the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the bill provides a special rule to address the factual situation presented in Munro.

Specifically, the bill provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS may only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court would be granted jurisdiction to determine the correctness of such an adjustment. No tax would be due upon such a determination, but a decision of the Tax Court would be treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that would be deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS would have preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the bill provides that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the bill incorporates a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures would not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings would be controlling.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

2. Permit the IRS to rely on partnership returns to determine the proper audit procedures (sec. 212 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership items is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Simplification

The IRS often finds it difficult to determine whether to follow the TEFRA partnership procedures or the regular deficiency procedures. If the IRS determines that there were fewer than 10 partners in the partnership but was unaware that one of the partners was a nonresident alien or that there was a special allocation made during the year, the IRS might inadvertently apply the wrong procedures and possibly jeopardize any assessment. Permitting the IRS to rely on a partnership's return would simplify the IRS' task.

Explanation of Provision

The bill permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the bill permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

3. Suspend statute of limitations during bankruptcy proceedings (sec. 213 of the bill and sec. 6229 of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Reasons for Simplification

The ambiguity in present law makes it difficult for the IRS to adjust partnership items that convert to nonpartnership items by reason of a partner going into bankruptcy. In addition, any uncertainty may result in increased requests for the bankruptcy court to lift the automatic stay to permit the IRS to make an assessment with respect to the converted items.

Explanation of Provision

The bill clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision shall take effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

4. Expand small partnership exception from TEFRA (sec. 214 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Simplification

The mere existence of a C corporation as a partner or of a special allocation does not warrant subjecting the partnership and its partners of an otherwise small partnership to the TEFRA procedures.

Explanation of Provision

The bill permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the bill retains the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

5. Exclude partial settlements from 1-year assessment rule (sec. 215 of the bill and sec. 6229(f) of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Reasons for Simplification

When a partial settlement agreement is entered into, the assessment period for the items covered by the agreement may be different than the assessment period for the remaining items. This fractured statute of limitations poses a significant tracking problem for the IRS and necessitates multiple computations of tax with respect to each partner's investment in the partnership for the taxable year.

Explanation of Provision

The bill provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items would be determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year shall be controlling with respect to all disputed partnership items for the partnership taxable year. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

6. Extend time for filing a request for administrative adjustment (sec. 216 of the bill and sec. 6227 of the Code)

Present Law

The non-TEFRA statute of limitations provides that if a statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Reasons for Simplification

The absence of an extension for filing refund claims in TEFRA proceedings hinders taxpayers that may want to agree to extend the TEFRA statute of limitations but want to preserve their option to file a refund claim later.

Explanation of Provision

The bill provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims until 6 months after the expiration of the limitations period for assessments.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

7. Provide innocent spouse relief for TEFRA proceedings (sec. 217 of the bill and sec. 6230 of the Code)

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Reasons for Simplification

Providing a forum in which to raise the innocent spouse defense with respect to liabilities attributable to adjustments to partnership items (including penalties, additions to tax and additional amounts) would make the innocent spouse rules more uniform.

Explanation of Provision

The bill provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

8. Determine penalties at the partnership level (sec. 218 of the bill and sec. 6221 of the Code)

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Reasons for Simplification

Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

Explanation of Provision

The bill provides that the partnership level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the bill allows partners to raise any partner-level defenses in a refund forum.

Effective Date

The provision is effective for partnership taxable years ending after December 31, 1991.

9. Clarify jurisdiction of the Tax Court (sec. 219 of the bill and secs. 6225 and 6226 of the Code)

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Reasons for Simplification

Clarifying the Tax Court's jurisdiction simplifies the resolution of tax cases.

Explanation of Provision

The bill clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The bill also permits a party to appear before a court for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person.

Effective Date

The provision is effective for partnership taxable years ending after the date of the enactment of this Act.

10. Treatment of premature petitions filed by certain partners (sec. 220 of the bill and sec. 6226 of the Code)

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Reasons for Simplification

A petition that is filed within the 90-day period by a person who is not the Tax Matters Partner is dismissed. Thus, if the Tax Matters Partner does not file a petition within the 90-day period and no timely and valid petition is filed during the succeeding 60-day period, judicial review of the adjustments set forth in the notice of FPAA is foreclosed and the adjustments are deemed to be correct.

Explanation of Provision

The bill treats premature petitions filed by certain partners within the 90-day period will be treated as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

The bill is effective with respect to petitions filed after the date of the enactment of this Act.

11. Clarify bond requirement for appeals from TEFRA proceedings (sec. 221 of the bill and sec. 7485 of the Code)

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Reasons for Simplification

The Tax Court cannot easily determine the aggregate changes in tax liability of all of the partners in a partnership who will be affected by the Court's decision in the proceeding. Clarifying the calculation of the bond amount would simplify the Tax Court's task.

Explanation of Provision

The bill clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership).

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

12. Suspend interest where there is a delay in computational adjustment resulting from TEFRA settlements (sec. 222 of the bill and sec. 6601 of the Code)

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Reasons for Simplification

Processing settlement agreements and assessing the tax due takes a substantial amount of time in TEFRA cases. A taxpayer is not afforded any relief from interest during this period.

Explanation of Provision

The bill suspends interest where there is a delay in a computational adjustment resulting from TEFRA settlements.

Effective Date

The provision is effective with respect to settlements entered into after December 31, 1991.

Title III.-- Foreign Provisions

1. Deferral of tax on income earned through foreign corporations and exceptions to deferral (secs. 301-304 of the bill and secs. 453, 532, 535, 542, 543, 551-558, 563, 954, 1246-1247, and 1291-1297 of the Code)

Present Law

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates that income by payment to its U.S. stockholders. The U.S. stockholders are subject to U.S. tax on the repatriated income at that time. Foreign tax credits may reduce the U.S. tax.

Since 1937, the Code has set forth one or more regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation. These regimes currently include the controlled foreign corporation (or subpart F) rules (secs. 951-964); the foreign personal holding company rules (secs. 551-558); passive foreign investment company (PFIC) rules (secs. 1291-1297); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247). These regimes have multiple and overlapping application to foreign corporations owned in whole or in part by U.S. persons.

Reasons for Simplification

Some of the different anti-deferral regimes were enacted or modified at different times and reflect historically different Congressional policies. Different regimes provide different thresholds (either by type of income or asset at the foreign corporation level, or of U.S. stock ownership at the shareholder level) to their application. They provide for different mechanisms by which U.S. stockholders are denied the benefits of deferral. Some of the regimes have features directed at policy goals applicable to foreign corporations owned by U.S. corporations (e.g., the allowance of indirect foreign tax credits); others have features primarily directed at issues applicable to foreign corporations owned by U.S. individuals (e.g., the basis of property acquired from a decedent). Some regimes preserve the character of the income earned in the hands of a foreign corporation while others do not. Some provide for movement of losses between years of a single foreign corporation or between multiple corporations while others do not. While a consistent theme of these regimes is to provide current taxation for certain types of interest, dividend, rental, royalty, and other similar income, the different regimes apply different criteria to these items of income to determine their current inclusion or noninclusion. Different regimes have different ordering rules for determining which dividends from foreign corporations subject to the regimes are subject to tax on repatriation and which are simply distributions of previously taxed income.

Simply because of the differences among the various anti-deferral regimes, U.S. taxpayers frequently are faced with the need to consult multiple sets of anti-deferral rules when they hold stock in a foreign corporation.

Moreover, the interactions of the rules cause additional complexity. There is significant overlap among the several regimes. This overlap requires the Code to provide specific rules of priority for income inclusions among the regimes, as well as additional coordination provisions pertaining to other operational differences among the several regimes. The overlapping or multiple application of anti-deferral regimes to a single corporation can result in significant additional complexity with little or no ultimate tax consequences.

Consolidation of the several anti-deferral regimes can achieve two major types of simplification. First, by reducing the number of separate definitions of entities among the anti-deferral regimes, taxpayers can be spared the burden of understanding and complying with a multiplicity of separate anti-deferral regimes with separate definitions and requirements.

Second, from an operational perspective, the number of anti-deferral regimes that can apply to any one shareholder in a foreign corporation can be reduced to one. As discussed above, the operational differences, including the overlapping applicability of the six present-law anti-deferral regimes, is a source of complexity. Under a consolidated regime, however, deferral can be denied for many corporations (whether in full or in part) solely through the provisions of subpart F. In the case of a controlled foreign corporation, for example, being subject to the rules for full denial of deferral (such as the PFIC or foreign personal holding company provisions under present law) can result in no additional compliance burdens or administrative or operational complexity.

Another source of complexity under present law is the need for shareholders of controlled foreign corporations to make "protective" current-inclusion elections in order to avoid adverse future consequences under the interest-charge method should the controlled foreign corporation also prove to be a PFIC.[16] By replacing elective current-inclusion treatment for PFICs that are also controlled foreign corporations by mandatory current inclusion through subpart F for passive foreign corporations that are also controlled foreign corporations, a consolidated regime can eliminate both the burdens of making protective elections and the risks of failing to do so.

It is understood that the interest-charge method of the present-law PFIC rules is a significant source of complexity both separately and in its interaction with other provisions of the Code. Even without eliminating the interest-charge method, significant simplification can be achieved by minimizing the number of taxpayers that may be subject to the method and by making certain modifications that may reduce the complexity engendered by the interest-charge method.

Explanation of Provision

In general

The bill replaces the separate anti-deferral regimes of present law with a unified set of rules providing for either partial or full elimination of deferral depending on the circumstances. The bill preserves the present-law approach under which partial current taxation is a function of the type of income earned by the foreign corporation and a level of U.S. ownership in the corporation exceeding some threshold (as currently embodied in subpart F). The bill also preserves the present-law approach under which full current taxation is a function of a type of income or assets of the corporation exceeding some threshold (as currently embodied in subpart F, the PFIC rules, and the foreign personal holding company rules). The bill eliminates regimes that are redundant or marginally applicable, and ensures that no more than one set of rules will ever apply to a shareholder's interest in any one corporation in any one year.

Generally, the bill retains the subpart F rules as the foundation of its unified anti-deferral regime (with certain modifications described below and also in item 2., following, describing secs. 311-313 of the bill). It includes a modified version of the PFIC rules while eliminating the other regimes as redundant to one or the other. The bill's unified anti-deferral regime sets forth various thresholds for subjecting U.S. persons to full or partial inclusions of corporate income. In addition, where deferral is eliminated by U.S. shareholder inclusions of foreign corporate-level income, the bill applies a single set of rules (the subpart F rules) for basis adjustments, characterization of actual distributions, foreign tax credits, and similar issues. As under present law, the bill in some cases affords U.S. persons owning stock in foreign corporations a choice of technique for recognizing income from the elimination of deferral. However, in a greater number of cases than under present law, the bill provides only one method of eliminating deferral.

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[16] For example, the "once a PFIC always a PFIC" rule of sec. 1297(b)(1) does not apply to shareholders that make current-inclusion elections.

Replacement of current law regimes for full elimination of deferral

The bill creates a single definition of a passive foreign corporation (PFC) that will unify and replace the foreign personal holding company and PFIC definitions. The rules applicable to PFCs represent a hybrid of characteristics of the foreign personal holding company rules, the PFIC rules, and the controlled foreign corporation rules (subpart F), plus a new mark-to-market regime, as well as a variety of simplifying or technical changes to rules under the existing systems. The following discussion explains the differences between the PFIC provisions of present law and the PFC provisions that will be applicable under the bill.

A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust.[17] As under the PFIC rules, the foreign corporation is permitted to elect to measure its assets based on their adjusted basis rather than their value.

As under present law, passive income for this purpose is defined in the bill generally as any income of a kind which would be foreign personal holding company income as defined in section 954(c), subject to the current law exceptions for banking and insurance income and the current look-through rules for certain payments from related persons (current sec. 1296(b)(2)).[18] In addition, the bill provides two clarifications to present law. First, the bill clarifies that, as indicated in the legislative history of the 1988 Act, the same-country exceptions from the definition of foreign personal holding company income in section 954(c) are disregarded.[19] Second, the bill clarifies that any foreign trade income of a foreign sales corporation does not constitute passive income for purposes of the PFIC definition (cf. sec. 951(e)).

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[17] It is understood that a mutual insurance company could be treated under the bill and under present law as a passive foreign corporation, notwithstanding the fact that such a company does not actually issue "stock."

(Footnote continued)

The bill modifies the present law application of the asset test by treating certain leased property as assets held by the foreign corporation for purposes of the PFC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months.

The bill also modifies the present law rules that provide an exception from the definition of a PFIC in the case of a company changing businesses. Under the bill, if a foreign corporation holds 25 percent or more of the stock of a second corporation that qualifies for the change-of-business exception (current sec. 1297(b)(3)), then in applying the look-though rules (current sec. 1296(c)), the first corporation may treat otherwise passive assets or income of the second corporation as active.[20]

The bill generally retains those provisions of current law the application of which depends upon whether a foreign corporation was a PFIC for years after 1986 (e.g., current sec. 1291(d)), but modifies these provisions to test whether the foreign corporation was a PFC for years after 1986. As a

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[18] (continued)

Thus, the bill retains the exception for income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. It is intended that in determining whether a corporation is "predominantly engaged" for this purpose, the Secretary may require a higher standard or threshold than the definition of an insurance company under Treasury Regulations section 1.801-3(a).

[19] H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 272 (1988); S. Rep. No. 100-445, 100th Cong., 2d Sess. 285 (1988).

[20] The bill retains the present law rules that provide an exception from the definition of a PFIC in the case of a start-up company (current sec. 1297(b)(2)). Under the bill, the start-up company exception is intended to be applied, where necessary to carry out the purposes of the PFC rules, by treating as one corporation all related foreign corporations that transferred assets to the start-up company.

transitional definition, the bill provides that a foreign corporation that was treated as a PFIC for any taxable year beginning before the introduction of the bill is treated as having been a PFC for each such year.

The bill provides a new election that will allow certain passive foreign corporations to be treated as domestic corporations. A foreign corporation is eligible to make this election if (1) it would qualify for treatment as a regulated investment company (RIC) under the relevant provisions of the Code if it actually were a domestic corporation, (2) it meets such requirements as the Secretary may prescribe to ensure the collection of taxes imposed by the Internal Revenue Code on the passive foreign corporation, and (3) the electing passive foreign corporation waives all benefits which are granted by the United States under any treaty (including treaties other than tax treaties) and to which the corporation is otherwise entitled by reason of being a resident of another country. The rules governing such an election will be similar to those applicable to the election by a foreign insurance company to be treated as a domestic corporation under section 953(d).

The bill provides a special rule regarding the application of the PFC rules to tax-exempt organizations that own stock in passive foreign corporations. The passive foreign corporation rules, under the bill, have no application at all to any organization exempt from tax under section 501, unless the organization is subject to unrelated business income taxation on its investment income under section 512(a)(3) of the Code. In the case of a tax-exempt organization that is subject to tax on its investment income, the PFC rules apply with respect to amounts taken into account in computing unrelated business taxable income in the same manner as if the organization were fully taxable.

Tax treatment under full elimination of deferral

The benefits of deferral are eliminated with respect to the income of a PFC under three alternative methods: current inclusion, mark-to-market, or interest charge on excess distributions.

Current inclusion method

Mandatory current inclusion.--If a passive foreign corporation is U.S. controlled, the bill will subject every U.S. person owning (directly or indirectly) stock in the PFC to income inclusions under a modified version of the controlled foreign corporation rules. If a PFC is not U.S. controlled, every U.S. person owning (directly or indirectly) 25 percent or more of the vote or value of the stock of the PFC will be subject to the same rules. Under the bill, the entire gross income of the passive foreign corporation (subject to applicable deductions) is treated as foreign personal holding company income, and thus is included (net of appropriate deductions) on a pro rata basis in the income of each U.S. person directly or indirectly owning stock in the PFC, under a modified application of the rules of sections 951 and 961. Actual distributions of earnings by such a PFC are treated similarly to distributions of previously taxed income under section 959 and 961. These rules supersede all application of the present-law rules applicable to foreign personal holding companies, under which earnings are deemed distributed and then contributed to the capital of the foreign personal holding company.

In applying the subpart F inclusion rules to PFC inclusions, the bill departs from subpart F in that foreign personal holding company income is included in the income of U.S. persons without regard to otherwise applicable reductions pursuant to the high-tax exception (under sec. 954(b)(4)) or the export trade corporation rules (secs. 970 and 971). This modification to the application of the controlled foreign corporation rules preserves present law in that no high-tax exception generally is available to PFICs or foreign personal holding companies, and that the PFIC provisions apply in full force to export trade corporations.

A passive foreign corporation is treated under the bill as U.S. controlled for this purpose either if it would be treated as a controlled foreign corporation under the rules of subpart F, or if, at any time during the taxable year, more than 50 percent of the vote or value of the corporation's stock were owned directly or indirectly by five or fewer U.S. persons (including but not limited to individuals, and including all U.S. citizens regardless of their residence). Indirect stock ownership under the bill generally refers to stock ownership through foreign entities within the meaning of section 958(a)(2). In addition, for the purpose of determining whether a foreign corporation is U.S. controlled by virtue of the ownership of more than 50 percent of its stock by five or fewer U.S. persons, the constructive ownership principles of the present-law foreign personal holding company rules apply.

Elective current inclusion.--A U.S. person not subject to the above mandatory current inclusion rules--that is, a U.S. person owning less than 25 percent of the stock in a PFC that is not U.S. controlled--may elect application of those rules. As under current law, the PFC is characterized as a "qualified electing fund" with respect to such a U.S. person. In the application of the elective current-inclusion rules, the passive foreign corporation is treated as a controlled foreign corporation with respect to the taxpayer, and the taxpayer is treated as a U.S. shareholder of the corporation. For foreign tax credit purposes, amounts included in the taxpayer's gross income under this modified application of the controlled foreign corporation rules are treated as dividends received from a foreign corporation which is not a controlled foreign corporation.

The application and operation of the shareholder-level election for treatment as a qualified electing fund generally are the same as under the present-law PFIC rules. It is intended that, in the case of PFC stock owned through a foreign partnership, a partner-level election for treatment as a qualified electing fund will be permitted (except in the case of a foreign partnership that is subject to the simplified reporting rules available to certain large partnerships under title II of the bill).

Mark-to-market method

Less-than-25-percent shareholders of passive foreign corporations that are not U.S.-controlled, and who do not elect current inclusion ("nonelecting shareholders"), are subject under the bill to one of two methods for taxing the economic equivalent of the PFC's current income: the mark-to-market method or the interest-charge method.

Under the bill, nonelecting shareholders of a PFC with marketable stock are required to mark their PFC shares to market annually. Under the mark-to-market method, the U.S. person is required to include in gross income each taxable year an amount equal to the excess (if any) of the fair market value of the PFC stock as of the close of the taxable year over the adjusted basis of the stock. In the event the adjusted basis of the stock exceeds its fair market value, the U.S. person is allowed a deduction for the taxable year equal to the lesser of the amount of the excess or the "unreversed inclusions" with respect to the stock. The bill defines the term "unreversed inclusions" to mean, with respect to any stock in a passive foreign corporation, the excess (if any) of the total amount of mark-to-market gains with respect to the stock included by the taxpayer for prior taxable years, over the amount of mark-to-market losses with respect to such stock that were allowed as deductions for prior taxable years.

The adjusted basis of stock in a passive foreign corporation is increased by the amount of mark-to-market gain included in gross income, and is decreased by the amount of mark-to-market losses allowed as deductions with respect to such stock. In the case of stock owned indirectly by the U.S. person, such as through a foreign partnership, foreign estate or foreign trust (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFC stock in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFC stock.

All amounts of mark-to-market gain on PFC stock, as well as gain on the actual sale or distribution of PFC stock, are treated as ordinary income. Similarly, ordinary loss treatment applies to the deductible portion of any mark-to-market loss on PFC stock, as well as to any loss realized on the actual sale or other disposition of PFC stock to the extent that the amount of such loss does not exceed the unreversed inclusions with respect to that stock. These loss deductions are treated as deductions allowable in computing adjusted gross income.

The source of any amount of mark-to-market gain on PFC stock is determined in the same manner as if the amount of income were actual gain from the sale of stock in the passive foreign corporation. Similarly, the source of any amount allowed as a deduction for mark-to-market loss on PFIC stock is determined in the same manner as if that amount were an actual loss incurred on the sale of stock in the passive foreign corporation.

The mark-to-market method under the bill only applies to passive foreign corporations the stock of which is "marketable." PFC stock is treated as marketable if it is regularly traded on a qualified exchange, whether inside or outside the United States. An exchange qualifies for this treatment if it is a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or if the Secretary is satisfied that the requirements for trading on that exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock. It is intended that the Secretary may adopt a definition of the term "regularly traded" that differs from definitions provided for other purposes under the Code. Further, it is intended that the Secretary not be bound by definitions applied for purposes of enforcing other laws, including Federal securities laws. Similarly, in identifying qualified foreign exchanges for these purposes, it is intended that the Secretary not be required to include exchanges that satisfy standards established under Federal securities laws and regulations. PFC stock is also treated as marketable, to the extent provided in Treasury regulations, if the PFC continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the bill treats as marketable any stock in a passive foreign corporation that is owned by a RIC that continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value. It is believed that the RIC's determination of PFC stock value for this non-tax purpose would ensure a sufficiently accurate determination of the fair market value of PFC stock owned by the RIC. The bill also treats as marketable any stock in a passive foreign corporation that is held by any other RIC, except to the extent provided in regulations. It is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuations may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the stock they hold in PFCs. However, it is intended that Treasury regulations will disallow mark-to-market treatment for nonmarketable stock held by any RIC that is not required to perform such a net asset valuation at the close of each taxable year, that does not publish such a valuation, or that otherwise does not provide what the Secretary regards as sufficient indicia of the reliability of its valuations under the relevant circumstances.

The bill coordinates the application of the mark-to-market method with the tax rules generally applicable to RICs. The bill treats mark-to-market gain on PFC stock as a dividend for purposes of both the 90-percent investment income test of section 851(b)(2) and the 30-percent short-short limitation of section 851(b)(3).

The mark-to-market method does not apply to the stock of a U.S. person in any PFC that is U.S. controlled (as discussed above), to the stock of a person choosing qualified electing fund treatment, or to stock of a U.S. person who is a 25-percent shareholder (as defined above).

In the case of a controlled foreign corporation (including a passive foreign corporation that is treated under the bill as a controlled foreign corporation) that owns or is treated as owning stock in a passive foreign corporation, the mark-to-market method generally is applied as if the controlled foreign corporation were a U.S. person. For purposes of the application of subpart F to the controlled foreign corporation, mark-to-market gains are treated as if they were foreign personal holding company income of the character of dividends, interest, royalties, rents or annuities, and allowable deductions for mark-to-market losses are treated as deductions allocable to that category of foreign personal holding company income. The source of such income or loss, however, is determined by reference to the actual (foreign) residence of the controlled foreign corporation.

For purposes of the mark-to-market method, any stock in a passive foreign corporation that is owned, directly or indirectly, by or for a foreign partnership or foreign trust or foreign estate is treated as if it were owned proportionately by its partners or beneficiaries.[21] Stock in a passive foreign corporation that is thus treated as owned by a person is treated as actually owned by that person for the purpose of applying the constructive ownership rule at another level. In the case of a U.S. person who is treated as owning stock in a passive foreign corporation by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the stock in the passive foreign corporation, as well as any disposition by the person actually owning the stock of the passive foreign corporation, is treated under the bill as a disposition by the U.S. person of stock in the passive foreign corporation.

Interest-charge method

Nonelecting shareholders[22] of a PFC with stock that is not marketable are subject to the interest-charge method, based on the PFIC interest-charge method that is currently provided in Code section 1291, with certain modifications.

First, although allowable foreign tax credits may reduce a U.S. person's net U.S. tax liability on an excess distribution, the interest charge computed on that excess distribution is computed, under the bill, without regard to reductions in net U.S. tax liability on account of direct foreign tax credits.

The PFIC provisions of present law, to the extent provided in regulations, impose recognition of gain in the case of a transfer of PFIC stock in a transaction that would otherwise qualify for the nonrecognition provisions of the Code. The bill imposes that result as a general rule, except as otherwise provided in Treasury regulations. In addition, the bill requires that proper adjustment be made to the basis of property, held by the U.S. person, through which the U.S. person is treated as owning stock in the passive foreign corporation.

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[21] For this purpose, it is intended that proportionate ownership will take into account any special or discretionary allocations of the distributions or gains with respect to stock in the passive foreign corporation.

[22] All citizens (and residents) of the United States are included, irrespective of residence in a U.S. commonwealth or possession.

The PFIC provisions of present law apply rules for the attribution of ownership of PFIC stock to U.S. persons, including a rule that attributes PFIC stock owned by a corporation to any person who owns, directly or indirectly, 50 percent or more of the value of the stock of the corporation. Under the bill, the 50-percent threshold applies not only to stock owned directly or indirectly, but also to stock treated as owned by application of the family attribution rules of the personal holding company provisions (sec. 544 (c)(2)).

The PFIC provisions of present law provide special rules for the application of the interest-charge method in the case of PFIC stock held by an U.S. person through an intermediary entity. These rules describe the dispositions that are treated as dispositions of PFIC stock by the U.S. person, and include rules to eliminate the possibility of double taxation (sec. 1297(b)(5)). The bill clarifies that these rules apply to any transaction that results in the U.S. person being treated as no longer owning the PFC stock, as well as any disposition of the PFC stock by the entity actually owning the PFC stock. These rules apply regardless of whether the transaction involves a disposition of the PFC stock, and regardless of whether the parties to the transaction include the U.S. person, the entity actually owning the PFC stock, or some other entity. For example, these rules apply to the issuance of additional stock by an intermediary corporation to an unrelated party in a case where, by increasing the total outstanding stock of the intermediary corporation, the transaction causes the U.S. person to fall below the ownership threshold for indirect ownership of the PFC stock. The bill also clarifies that an income inclusion under the interest-charge method takes precedence over an income inclusion under subpart F resulting from the same disposition. The second clarification ensures that the interest charge is imposed without regard to the structure of the transaction.

Under the bill, the interest-charge method applies to any stock in a passive foreign corporation unless either the stock is marketable (and therefore the mark-to-market method applies) as of the time of the distribution or disposition involved, or the stock in the passive foreign corporation was subject to the current inclusion method (under the bill or under prior law) for each taxable year beginning after December 31, 1986 which includes any portion of the taxpayer's holding period in the PFC stock. In the event that PFC stock, not subject to the current inclusion method, becomes marketable during the taxpayer's holding period, the interest-charge method applies to any distributions and dispositions during the year in which the stock becomes marketable, as well as to the mark-to-market gain (if any) as of the close of that year. In the event that PFC stock was initially marketable, and later becomes unmarketable and subject to the interest-charge method, the taxpayer's holding period in the PFC stock for purposes of the interest-charge method is treated as beginning on the first day of the first taxable year beginning after the last taxable year for which the mark-to-market method applies to the taxpayer's stock in the PFC.

Under the bill, as under the present-law PFIC rules, stock in a foreign corporation generally is treated as PFC stock if, at any time during the taxpayer's holding period of that stock, the foreign corporation (or any predecessor) is a passive foreign corporation subject to the interest-charge method (current sec. 1297(b)(1)). (This rule is sometimes referred to as the "once-a-PFIC-always-a-PFIC" rule.) Under present law this rule generally does not affect a taxpayer holding stock in a foreign corporation if at all times during the holding period of the taxpayer with respect to the stock when the foreign corporation (or any predecessor) is a PFIC, qualied electing fund treatment applies with respect to the taxpayer. Under the bill, the similar once-a-PFC-always-a-PFC rule does not apply if during the taxpayer's entire holding period with respect to the stock when the foreign corporation (or any predecessor) is a PFC, either (a) mark-to-market treatment applies, (b) mandatory current inclusion of income applies (either because the corporation is U.S. controlled or because the taxpayer is a 25-percent shareholder), or (c) elective current inclusion of income applies. Thus, for example, a shareholder of a controlled foreign corporation is subject to current inclusion with respect to all the corporation's income in any year for which the corporation is a PFC, but is subject to current inclusion only to the extent provided under subpart F in any year for which the controlled foreign corporation is not a PFC.

The bill also provides for full basis adjustment for partnerships and S corporations that own stock in a passive foreign corporation subject to the interest-charge method. Although tax is imposed on a distribution or disposition under the interest-charge method without including the distribution or disposition in gross income, thus precluding the natural basis adjustments for amounts included in gross income, the bill grants regulatory authority for appropriate basis adjustments to partnerships and S corporations based on the amount of income subject to tax under the interest-charge method and thereby excluded from gross income.

The bill also includes a special rule to coordinate the application of the interest-charge method to nonelecting shareholders of a passive foreign corporation who are or were residents of Puerto Rico. Under the bill, no interest charge is applicable to amounts of an excess distribution that, were the amounts actually earned in the year to which they are treated as earned under the interest-charge method, would have been eligible for the exclusion under section 933 (for income derived by residents of Puerto Rico from sources within Puerto Rico).

The bill includes a broad grant of regulatory authority, as does the present-law PFIC statute. However, the bill specifies that necessary or appropriate regulations under the PFC rules may include regulations providing that gross income should be determined without regard to the operation of the interest-charge method for such purposes as may be specified in the regulations. This permits the Secretary to relieve pressure on many aspects of the Code that result from the operation of the interest-charge method other than through gross income. In addition, the bill specifies that necessary or appropriate PFC regulations may include regulations dealing with changes in residence status by shareholders in passive foreign corporations (e.g., a resident alien becoming a nonresident, or a U.S. citizen becoming a resident of Puerto Rico).

Modification or repeal of other antideferral regimes

While the bill includes in the passive foreign corporation rules most of the provisions that it preserves from the present-law PFIC, foreign personal holding company, and foreign investment company regimes, the bill modifies subpart F in one respect to reflect a present-law provision of the foreign personal holding company rules (sec. 553(a)(5)). The bill treats as foreign personal holding company income for subpart F purposes an amount received under a personal service contract if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The bill similarly treats as foreign personal holding company income for subpart F purposes any amount received from the sale or distribution or disposition of such a contract. This rule applies only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly, indirectly, or constructively) by or for the individual who may be designated to perform the services.[23] Income from such personal service contracts is not, however, treated as passive for foreign tax credit purposes.

The bill repeals the foreign personal holding company provisions, the PFIC provisions (except as modified and preserved as the passive foreign corporation provisions), and the foreign investment company provisions. The bill also excludes all foreign corporations from the application of the accumulated earnings tax and the personal holding company tax. It is understood that the purposes of all the anti-deferral regimes are adequately served by the passive foreign corporation provisions as set forth in the bill, in conjunction with the controlled foreign corporation provisions as modified by the bill.

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[23] This rule was included in the definition of foreign personal holding company income for purposes of subpart F prior to the amendments included in the 1986 Act.

In addition, the bill denies installment sales treatment for any installment obligation arising out of a sale of stock in a passive foreign corporation. This will prevent shareholders in passive foreign corporations from avoiding the interest charge by means of an installment sale of their PFC stock.

Effective Date

The bill generally is effective for taxable years of U.S. persons beginning after December 31, 1991, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

The denial of installment sales treatment is effective for sales or dispositions after December 31, 1991.

The bill does not affect the determination of the basis of stock in a PFIC that was acquired from a decedent in a taxable year beginning before January 1, 1991.

2. Modifications to provisions affecting controlled foreign corporations (secs. 311, 312, and 313 of the bill and secs. 951, 952, 959, 960, 961, 964, and 1248 of the Code)

Present Law

Treatment of controlled foreign corporation earnings

In general

A U.S. shareholder generally treats dividends from a controlled foreign corporation as ordinary income from foreign sources that carries both direct and indirect foreign tax credits. Under look-through rules, the income and credits are subject to those foreign tax credit limitations which are consistent with the character of the income of the foreign corporation.

Several Code provisions result in similar tax treatment of a U.S. shareholder if it either disposes of the controlled foreign corporation stock, or the controlled foreign corporation realizes certain types of income (including income with respect to lower-tier controlled foreign corporations). First, under section 1248, gain resulting from the disposition by a U.S. person of stock in a foreign corporation that was a controlled foreign corporation with respect to which the U.S. person was a U.S. shareholder in the previous five years is treated as a dividend to the extent of allocable earnings.

Second, a controlled foreign corporation has subpart F income when it realizes gain on disposition of stock and, ordinarily, when it receives a dividend. Under sections 951 and 960, such subpart F income may result in taxation to the U.S. shareholder similar (but not identical) to that on a dividend from the controlled foreign corporation. In addition to provisions for characterizing income and credits in these situations, the Code also provides certain rules that adjust basis, or otherwise result in modifying the tax consequences of subsequent income, to account for these and other subpart F income inclusions.

Third, when in exchange for property any corporation (including a controlled foreign corporation) acquires stock in another corporation (including a controlled foreign corporation) controlled by the same persons that control the acquiring corporation, earnings of the acquiring corporation (and possibly the acquired corporation) may be treated under section 304 as having been distributed as a dividend to the seller.

Lower-tier controlled foreign corporations

For purposes of applying the separate foreign tax credit limitations, receipt of a dividend from a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation may result in a subpart F income inclusion for the U.S. shareholder that is treated as income in the same limitation category as the income of the lower-tier controlled foreign corporation. The income inclusion of the U.S. shareholder may carry deemed-paid credits for foreign taxes paid by the lower-tier controlled foreign corporation, and the basis of the U.S. shareholder in the stock of the first-tier controlled foreign corporation is increased by the amount of the inclusion. If, on the other hand, the upper-tier controlled foreign corporation sells stock of a lower-tier controlled foreign corporation, then the gain is also included in the income of the U.S. shareholder as subpart F income and the U.S. shareholder's basis in the stock of the first-tier controlled foreign corporation is increased to account for the inclusion, but the inclusion is not treated for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier controlled foreign corporation. Instead it generally is treated as passive income.

If subpart F income of a lower-tier controlled foreign corporation is included in the gross income of a U.S. shareholder, there is no provision that adjusts the basis of the upper-tier controlled foreign corporation's stock of the lower-tier controlled foreign corporation.

Subpart F inclusions in year of disposition

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. shareholders of the corporation on the last day, in that year, on which the corporation is a controlled foreign corporation. In the case of a U.S. shareholder who acquired stock in a controlled foreign corporation in the middle of the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person besides the acquirer with respect to that stock. The reduction is determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Distributions of previously taxed income

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the controlled foreign corporation receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)). Thus, a portion of the foreign taxes paid or accrued by the foreign corporation and not previously deemed paid by the domestic corporation are treated as paid by the domestic corporation under the principles of section 902 even though the domestic corporation recognizes no income in the current taxable year with respect to the distribution.

In addition, the domestic corporation is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits in an amount equal to the excess of the amount by which its foreign tax credit limitation for the year of the subpart F inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the subpart F inclusion (sec. 960(b)). The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes taken into account under this provision with respect to the distribution of previously taxed earnings and profits. In order for this rule to apply, the domestic corporation either must have elected to credit foreign taxes in the year of the subpart F inclusion or must not have paid or accrued any foreign taxes in such year, and it must elect the foreign tax credit in the year of the distribution of previously taxed earnings and profits.

Treatment of United States source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the controlled foreign corporation. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Reasons for Simplification

It is believed that complexities have been caused by uncertainties and gaps in the statutory schemes for taxing gains on dispositions of stock in controlled foreign corporations as dividend income or subpart F income. These uncertainties and gaps may prompt taxpayers to refrain from behavior that would otherwise be the result of rational business decisions, for fear of excessive tax--for example, double corporate-level taxation of income. In many cases, concerns about excessive taxation can be allayed, but only at the cost of avoiding the simpler and more rational economic behavior in favor of tax-motivated planning.

It is understood that, as a general matter, other aspects of the tax system may have interfered with rational economic decision making by prompting taxpayers to engage in tax-motivated planning in order to eliminate taxation in cases where income is in fact earned. Some such characteristics of the tax system have in the past been altered by Congress in order to reduce excessive interference by the tax system in labor, investment, and consumption decisions of taxpayers.[24] It is believed that in the context of this simplification bill, it generally is appropriate to reduce complexities caused by aspects of the rules governing controlled foreign corporations that provide for nonuniform tax results from dividends, on the one hand, and stock disposition proceeds to the extent earnings and profits underlie those proceeds, on the other.

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[24] See, e.g., Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. General Explanation of the Tax Reform Act of 1986 at 6 et seq. (1987) ("General Reasons For The Act").

It is understood that the present-law provisions which permit an indirect foreign tax credit and an increased foreign tax credit limitation to be claimed in the event of a distribution of previously taxed earnings by a controlled foreign corporation are particularly difficult to administer. This difficulty arises because taxpayers are required to compute and keep track of excess foreign tax credit limitation accounts with respect to subpart F income inclusions on a foreign corporation by foreign corporation basis, as well as on a year by year basis. Additional complexities arise as taxpayers are required, as a result of distributions, to trace earnings and profits up chains of foreign corporations. It is believed that retention of these rules may not be worth the system-wide recordkeeping and computations involved. It is believed that the combination of foreign income tax rates on the foreign income of U.S. persons and their controlled foreign corporations, and the U.S. rules for taxing such income, will result in few cases where the effort will be rewarded by substantial tax savings. Moreover, it is believed that taxpayers who might be adversely affected may be able to plan around those adverse effects at less cost than the complexity cost that is engendered by the present system.

Explanation of Provisions

In general

The bill makes a number of modifications in the treatment of income derived from the disposition of stock in a controlled foreign corporation. The bill provides deemed dividend treatment for gains on dispositions of lower-tier controlled foreign corporations. Where the lower-tier controlled foreign corporation previously earned subpart F income, the bill permits the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions. Where proceeds from the sale of stock to a controlled foreign corporation that previously has earned subpart F income would be treated as a dividend under the principles of section 304, the bill expressly permits exclusion of the deemed section 304 dividend from taxation to the extent of the previously taxed earnings and profits of the controlled foreign corporation from which the property was deemed to be distributed. (Appropriate basis adjustments also are permitted to be made.) Where a controlled foreign corporation (whether or not it is a lower-tier controlled foreign corporation) earns subpart F income in a year in which a U.S. shareholder sells its stock, in a transaction that does not result in the foreign corporation ceasing to be a controlled foreign corporation, the bill contains statutory language providing for a proportional reduction in the taxation of the subpart F income in that year to the acquiring U.S. shareholder.

The bill contains two additional provisions related to controlled foreign corporations. First, the bill repeals the provision that currently permits an indirect foreign tax credit and an increased foreign tax credit limitation to be claimed upon certain distributions by controlled foreign corporations of previously taxed earnings and profits. Second, the bill clarifies the effect of a treaty exemption or reduction of the branch profits tax on the determination of subpart F income.

Lower-tier controlled foreign corporations

Characterization of gain on stock disposition

The bill provides that if a controlled foreign corporation is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the controlled foreign corporation were a U.S. person. However, this rule does not affect the determination of whether the second corporation is a controlled foreign corporation.

Thus, for example, if a U.S. corporation owns 100 percent of the stock a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the bill, any gain of the first corporation upon a sale of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a controlled foreign corporation with respect to the U.S. shareholder. As another example, assume that the U.S. corporation has always owned 51 percent of the stock of a foreign corporation, which has always owned 51 percent of the stock of a second foreign corporation. All the other stock of the foreign corporations has always been owned by other foreign individuals unrelated to the U.S. corporation. In this case, the second foreign corporation has never been a controlled foreign corporation. Therefore, none of the gain of the first corporation upon a sale of stock of the second corporation is treated as a dividend.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having substantial part of assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the bill, is not therefore excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

Adjustments to basis of stock

The bill also provides that when a lower-tier controlled foreign corporation earns subpart F income, and stock in that corporation is later sold by an upper-tier controlled foreign corporation, the resulting income inclusion of the U.S. shareholders are, under regulations, adjusted to account for previous inclusions, in a manner similar to the adjustments now provided to the basis of stock in a first-tier controlled foreign corporation. Thus, just as the basis of a U.S. shareholder in a first-tier controlled foreign corporation rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later sale, it is intended that by regulation the subpart F income from gain on the sale of a lower-tier controlled foreign corporation generally would be reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier controlled foreign corporation. It is intended that the Secretary will have sufficient flexibility in promulgating regulations under this provision to permit adjustments only in those cases where, by virtue of the historical ownership structure of the corporations involved, the Secretary is satisfied that the inclusions for which adjustments can be made can be clearly identified.

Subpart F inclusions in year of disposition

Where a U.S. shareholder acquires the stock of a controlled foreign corporation from another U.S. shareholder during the middle of a year in which the controlled foreign corporation earns subpart F income, the bill reduces the acquirer's subpart F inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced would (as is currently the case where a dividend was paid to the previous owner of the stock) not exceed the subpart F inclusion for that year times the proportion of the year for which the acquirer did not own the stock.

Avoiding double inclusions in other cases

The bill clarifies the appropriate scope of regulatory authority with respect to the treatment of cross-chain section 304 dividends out of the earnings of controlled foreign corporations that were previously included in the income of a U.S. shareholder under subpart F. The bill contemplates that in such a case, the Secretary in his discretion may by regulation treat such dividends as distributions of previously taxed income, with appropriate basis adjustments. It is also anticipated that other occasions may arise where the exercise of similar regulatory authority may be appropriate to avoid double income inclusions, or an inclusion or exclusion of income without a corresponding basis adjustment. Therefore, the bill states that, in addition to cases involving section 304, the Secretary may by regulation modify the application of subpart F in any other case where there would otherwise be a multiple inclusion of any item of income (or an inclusion or exclusion without an appropriate basis adjustment) by reason of the structure of a U.S. shareholder's holdings in controlled foreign corporations or by reason of other circumstances.

Foreign tax credit in year of receipt of previously taxed income

The bill repeals the rules that permit an indirect foreign tax credit to be claimed with respect to a distribution of previously taxed earnings and profits. Under the bill, foreign taxes paid by a foreign corporation with respect to previously taxed earnings and profits remain in that corporation's pool (or pools) of foreign taxes which are available for the indirect foreign tax credit upon subsequent distributions or deemed distributions of earnings and profits that have not been previously taxed at the U.S. shareholder level.

Treatment of United States income earned by a controlled foreign corporation

The bill provides that an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a controlled foreign corporation does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a controlled foreign corporation earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The bill provides that notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Effective Dates

Lower-tier controlled foreign corporations

The provision of the bill treating gains on dispositions of stock in lower-tier controlled foreign corporations as dividends under section 1248 principles applies to gains recognized on transactions occurring after date of enactment of the bill. The provision providing for regulatory adjustments in U.S. shareholder inclusions, with respect to gains of controlled foreign corporations from stock in lower-tier controlled foreign corporations that previously had subpart F income, is effective for U.S. shareholder inclusions in taxable years of U.S. shareholders beginning after December 31, 1991.

Subpart F inclusions in year of disposition

The provision of the bill permitting dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment of the bill.

Distributions of previously taxed income

The provision of the bill allowing the Secretary to make regulatory adjustments to avoid double inclusions in cases such as those to which section 304 applies takes effect on the date the bill is enacted.

Foreign tax credit on distribution of previously taxed income

The provision of the bill which repeals the ability to claim foreign tax credits on distributions of previously taxed income generally is effective for taxable years beginning after December 31, 1991. However, the provision is not effective with respect to distributions of previously taxed income which occur in taxable years beginning prior to January 1, 1997, if the distributions relate to subpart F income inclusions for taxable years of the U.S. corporate shareholders beginning before January 1, 1992.

Treatment of United States source income earned by a controlled foreign corporation

The provision of the bill concerning the effect of treaty exemptions from or reductions of the branch profits tax on the determination of subpart F income is effective for taxable years ending after the date of enactment.

3. Translation of foreign taxes into U.S. dollar amounts (sec. 321 of the bill and sec. 986(a) of the Code)

Present Law

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession (sec. 986(a)(1)). This rule applies equally to foreign taxes paid directly by U.S. taxpayers, which are creditable only in the year paid or accrued (or during a carryover period), and to foreign taxes paid by foreign corporations that are deemed paid by a U.S.

corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or income inclusion.

Reasons for Simplification

If each foreign income tax payment is required to be translated at a separate daily exchange rate for the day of the payment, the number of currency exchange rates that are relevant to foreign tax credit calculations varies directly with the frequency of foreign income tax payments. Where U.S. corporations are deemed to pay a portion of the "pool" of foreign taxes paid by foreign corporations, the correct amount of tax in the pool is the product of each tax payment times the relevant translation rate. The longer the period between the time the income is earned and its repatriation (or other inclusion) to the U.S. corporation, the greater the period over which the amounts of tax payments and translation rates are relevant to the determination of net U.S. tax liability.

It is believed that the record-keeping, verification, and examination burdens--both on the IRS and on taxpayers--associated with the advantages of deferral and the foreign tax credit (including the indirect credit) are not insignificant. For example, if events that happened in one year affected only the return filed for that year, and each tax return was affected only by events that happened in the year for which that return was filed, then presumably tax-related records would need to be maintained only between the time the taxable year began and the year that the assessment period for that year expired. On the other hand, if income earned in years 1 through 5 is taxed in year 6, then the amount of documentation relevant to the year 6 return potentially is increased five-fold, and the period over which that information must be maintained is at least five years longer.

U.S. persons who pay foreign income taxes directly and choose the benefits of the foreign tax credit have always been required to maintain detailed foreign tax payment documentation, including exchange rate data for the dates on which they paid foreign income taxes, and U.S. corporations that operate through foreign corporations have been required to maintain documentation regarding the earnings and foreign tax payments of the foreign corporations.[25] Some have argued, however, that relief is warranted for taxpayers that would otherwise bear the combined currency translation responsibilities applicable to direct foreign taxpayers with the extended record-keeping responsibilities applicable to taxpayers that receive the benefits of deferral.

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[25] Also, note that in Commissioner v. American Metal Co., 221 F.2d 134,141 (2d. Cir.), cert. denied, 350 U.S. 879 (1955), where a foreign corporation kept its books in U.S. dollars, foreign taxes were translated as of their payment date.

It is believed that an appropriate response to this combination of burdens is to permit regulatory modification of the "time of payment" concept, in such a way that preserves the uniformity of treatment of branches and foreign subsidiaries of U.S. taxpayers, but permits recourse to reasonably accurate average translation rates for the period in which the tax payments are made. Simplification may be provided in this way by reducing, sometimes substantially, the number of translation calculations that are required to be made. There may be situations in which the use of an average exchange rate over a specified time period, to be applied to all tax payments made in that currency during that period, would provide results not substantially different than those that would be derived under present law. This could result, for example, where the value of a foreign currency as it relates to the U.S. dollar does not fluctuate significantly over the specified period.

One of the fundamental premises behind the amendments enacted in 1986 with respect to the translation of foreign taxes was that foreign taxes paid by foreign corporations should be translated in the same manner as foreign taxes paid by foreign branches of U.S. persons. In keeping with that premise, it is believed that any provision to allow the use of average exchange rates for this purpose should be made equally applicable to foreign branches and subsidiaries.

Explanation of Provision

The bill grants the Secretary of the Treasury authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period. It is anticipated that the applicable average exchange rate would be the rate as published by a qualified source of exchange rates for the period during which the tax payments were made.

Effective Date

This provision is effective with respect to taxable years beginning after the date of enactment.

4. Foreign tax credit limitation under the alternative minimum tax (sec. 322 of the bill and sec. 59(a) of the Code)

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source and U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Reasons for Simplification

The process of allocating and apportioning deductions for purposes of calculating the regular and AMT foreign tax credit limitations can be complex. Taxpayers that have allocated and apportioned deductions for regular tax foreign tax credit purposes generally must reallocate and reapportion the same deductions for AMT foreign tax credit purposes, based on assets and income that reflect AMT adjustments (including depreciation). However, the differences between regular taxable income and alternative minimum taxable income are often relevant primarily to U.S. source income. As a result of the combined effects of these differences, it is believed that foreign source alternative minimum taxable income generally will not differ significantly from foreign source regular taxable income. By permitting taxpayers to use foreign source regular taxable income in computing their AMT foreign tax credit limitation, the bill eliminates the need to reallocate and reapportion every deduction.

Explanation of Provision

The bill permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source _regular_ taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source _alternative minimum_ taxable income to entire alternative minimum taxable income. Foreign source regular taxable income may be used, however, only to the extent it does not exceed entire alternative minimum taxable income.

The election under the bill is available only in the first taxable year beginning after December 31, 1991, for which the taxpayer claims an alternative minimum tax foreign tax credit. The election applies to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

Title IV.--Other Income Tax Provisions

A. Provisions Relating to S Corporations

1. Determination of whether an S corporation has one class of stock (sec. 401 of the bill and sec. 1361 of the Code)

Present Law

Under present law, a small business corporation eligible to be an S corporation may not have more than one class of stock. Differences in voting rights are disregarded in determining whether a corporation has more than one class of stock. In addition, certain debt instruments may not be treated as a second class of stock for purposes of this rule.

The Treasury Department has issued proposed regulations[26] providing that a corporation will have more than one class of stock if all of the outstanding shares of stock do not confer identical rights to distribution and liquidation proceeds, regardless of whether any differences in rights occur pursuant to the corporate charter, articles or bylaws, by operation of State law, by administrative action, or by agreement. The proposed regulations also provide that, notwithstanding that all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation has more than one class of stock if the corporation makes non-conforming distributions (i.e., distributions that differ with respect to timing or amount with respect to each share of stock), with limited exceptions for certain redemptions and certain differences in the timing of distributions.

Reasons for Simplification

The provision promotes simplification by eliminating traps for the unwary that would be inherent in rules that use nonconforming distributions regardless of the rights of the shareholders as evidence of additional classes of stock.

Explanation of Provision

The bill provides that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Applicable State law, determined by taking into account legally enforceable rights under the corporate charter, articles or bylaws, administrative action, and any agreements, determines whether the outstanding shares confer different rights to distribution or liquidation proceeds.

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[26] Proposed Treasury Regulation sec. 1.1361-1(l)(2).

Where an S corporation in fact makes distributions which differ as to timing or amount, the bill in no way limits the Internal Revenue Service from properly characterizing the transaction for tax purposes. For example, if a distribution is properly characterized as compensation, the Service could require it to be so treated for tax purposes. Similarly, if a payment should be properly characterized as a distribution, the Service could require it to be so treated for tax purposes.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.

2. Authority to validate certain invalid elections (sec. 402 of the bill and sec. 1362 of the Code)

Present Law

Under present law, if the Internal Revenue Service determines that a corporation's Subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Present law does not grant the Internal Revenue Service the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The Internal Revenue Service may not validate a late election.

Reasons for Simplification

The bill promotes simplification by giving the Secretary the flexibility to validate an invalid S election where the failure to properly elect S status was inadvertent or untimely.

Explanation of Provision

Under the bill, the authority of the Internal Revenue Service to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents.

The bill also allows the Internal Revenue Service to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.[27]

3. Treatment of distributions by S corporations during loss year (sec. 403 of the bill and secs. 1366 and 1368 of the Code)

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of the stock.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules appear to require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.[28]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.[29]

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[27] This is the effective date of the present-law provision regarding inadvertent terminations.

[28] *See* section 1366(d)(1)(A); H. Rep. 97-826, p. 17; S. Rep. 97-640, p. 18.

In addition, if the S corporation has accumulated earnings and profits,[30] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Reasons for Simplification

The provision promotes simplification by conforming the S corporation rules regarding distributions to the partnership rules and by eliminating uncertainty regarding the treatment of distributions made during the year.

Explanation of Provision

The bill provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The bill also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1.--X is the sole shareholder of A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1992, is

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[29] Treas. Reg. sec. 1.704-1(d)(2); Rev. Rul. 66-94, 1966-1 C.B. 166.

[30] An S corporation may have earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.

$1,000 and X holds no debt of A. During the taxable year, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.--The facts are the same as in Example 1, except that on January 1, 1992, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1993, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against A's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1993, is $100 ($1,000 plus $200 less $200 less $900).

Effective Date

These provisions apply to distributions made in taxable years beginning after December 31, 1991.

4. Treatment of S corporations as shareholders in C corporations (sec. 404(a) of the bill and sec. 1371 of the Code)

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The Internal Revenue Service has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[31] Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free.[32] Also, the Service's reasoning would also prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

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[31] *See* PLR 8818049, (Feb. 10, 1988).

[32] A tax is imposed with respect to LIFO inventory held by a C corporation becoming an S corporation.

Reasons for Simplification

The provision promotes simplification by treating similar transactions in a similar manner for tax purposes.

Explanation of Provision

The bill repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation will also be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

No inference is intended regarding the present-law treatment of these transactions.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

5. S corporations permitted to hold subsidiaries (sec. 404(b) of the bill and sec. 1361 of the Code)

Present Law

Under present law, an S corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). The legislative history indicates that this rule was adopted to prevent the filing of consolidated returns by a group which includes an S corporation.[33]

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[33] See S. Rpt. No. 1983 (85th Cong., 2d Sess., 1958), p. 88.

Reasons for Simplification

The provision promotes simplification by eliminating a barrier to using the S corporation form of entity and providing more appropriate treatment of corporations with subsidiaries, i.e., the prohibition of filing a consolidated return if S corporate status is elected rather than disqualification of the S election.

Explanation of Provision

The bill repeals the rule that an S corporation may not be a member of an affiliated group of corporations. Thus, an S corporation will be allowed to own up to 100 percent of the stock of a C corporation. However, an S corporation cannot be included in a group filing a consolidated return.

Under the bill, if an S corporation holds 100 percent of the stock of a C corporation that, in turn, holds 100 percent of the stock of another C corporation, the two C corporations may elect to file a consolidated return (if otherwise eligible), but the S corporation may not join in the election.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

6. Elimination of pre-1983 earnings and profits of S corporations (sec. 404(c) of the bill)

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits to the extent its undistributed earnings and profits for the year exceeded its taxable income. As a result of this rule, a shareholder may later be required to include in his income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Reasons for Simplification

The provision promotes simplification by eliminating the need to keep records of certain generally small amounts of earnings arising before 1983.

Explanation of Provision

The bill provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1991, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits will be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his share of the taxable income of the S corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

7. Determination of shareholder's pro rata share where disposition of entire interest (sec. 404(d) of the bill and sec. 1377(a)(2) of the Code)

Present Law

Under present law, a shareholder of an S corporation takes into account separately his pro rata share of items of income, deduction, credit, etc. of the corporation. For this purpose, a shareholder's pro rata share means an allocation based on a per-share, per-day basis. However, in the case of a termination of a shareholder's interest, the corporation, with the consent of all shareholders, may elect to allocate items as if the taxable year ended on the date of termination and another taxable year began the following day.

Reasons for Simplification

The provision provides simplification by allowing a selling shareholder to be certain that his share of income will not be affected by income earned after the sale.

Explanation of Provision

Under the bill, the present-law rule, allowing a corporation to elect to close its books for purposes of determining shares of income on the termination of a shareholder's interest, will be the mandatory rule in the case of the disposition of a shareholder's entire interest in the corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

8. Treatment of items of income in respect of a decedent held by an S corporation (sec. 404(e) of the bill and sec. 1367 of the Code)

Present Law

Income in respect of a decedent (IRD) generally consists of items of gross income that accrued during the decedent's lifetime but were not yet includible in the decedent's income before his death under his method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to the person who includes the item in gross income (sec. 691(c)).

The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis often is referred to as a "stepped-up basis". Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD.[34] Although S corporation income is included in the income of the shareholders in a manner similar to the inclusion of partnership income in the income of the partners, no comparable regulation provides for a reduction in the basis of stock of an S corporation acquired from a decedent where the S corporation holds items of IRD on the date of death of a shareholder. Thus, under present law, the treatment of an item of IRD held by an S corporation is unclear.

Reasons for Simplification

The provision promotes simplification by eliminating the uncertainty of present law, and by treating items of IRD held by a taxpayer directly, through a partnership, or through an S corporation in a similar manner.

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[34] Treas. Reg. sec. 1.742-1.

Explanation of Provision

The bill provides that a person acquiring stock in an S corporation from a decedent is to treat as IRD his pro rata share of any item of income of the corporation which would have been IRD if that item had been acquired directly from the decedent. Where a item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock will be reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

No inference is intended regarding the present-law treatment of IRD in the case of S corporations.

Effective Date

The provision applies with respect to decedents dying after date of enactment of the bill.

B. Accounting Provisions

1. Modifications to the look-back method for long-term contracts (sec. 411 of the bill and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[35] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

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[35] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

Reasons for Simplification

Present law may require multiple applications of the look-back method with respect to a single contract or may otherwise subject contracts to the look-back method even though the amounts necessitating the look-back computations are de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicates the mechanics of the look-back method.

Explanation of Provisions

Election not to apply the look-back method for de minimis amounts

The bill provides that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but would not be required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1.--A taxpayer enters into a three-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is $100,000, $150,000, and $250,000, respectively, for Years 1, 2, and 3 under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between $90,000 and $110,000 as of the end of Year 1; and between $225,000 and $275,000 as of the end of Year 2.

Election not to reapply the look-back method

The bill provides that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract are not discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2.--A taxpayer enters into a three-year contract and reports taxable income of $12,250, $15,000 and $12,750, respectively, for Years 1 through 3 with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (Years 4, 5, and 6) with respect to the contract. Under the bill, an electing taxpayer does not reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for Year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of contract look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for Year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of contract look-back income as of the last application of the look-back method ($35,000).

Interest rates used for purposes of the look-back method

The bill provides that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

The provisions apply to contracts completed in taxable years ending after the date of enactment.

2. Simplified method for applying uniform cost capitalization rules (sec. 412 of the bill and sec. 263A of the Code)

Present Law

In general, the uniform cost capitalization rules require taxpayers that are engaged in the production of real or tangible personal property or in the purchase and holding of property for resale to capitalize or include in inventory the direct costs of the property and the indirect costs that are allocable to the property. In determining whether indirect costs are allocable to production or resale activities, taxpayers are allowed to use various methods so long as the method employed reasonably allocates indirect costs to production and resale activities.

Reasons for Simplification

The uniform cost capitalization rules require taxpayers to determine for each taxable year the costs of each administrative, service, or support function or department that are allocable to production or resale activities. If a taxpayer does not elect any of the simplified methods provided in Treasury regulations, this allocation may be unduly burdensome and costly.

Explanation of Provision

The bill authorizes (but does not require) the Treasury Department to issue regulations that allow taxpayers in appropriate circumstances to determine the costs of any administrative, service, or support function or department that are allocable to production or resale activities by multiplying the total amount of costs of any such function or department by a fraction, the numerator of which is the amount of costs of the function or department that was allocable to production or resale activities for a base period and the denominator of which is the total amount of costs of the function or department for the base period. It is anticipated that the regulations will provide that the base period is to begin no earlier than 4 taxable years prior to the taxable year with respect to which this simplified method applies.

Effective Date

The provision applies to taxable years beginning after the date of enactment of the bill. Thus, the regulations may permit the use of the simplified method for taxable years beginning after this date. The simplified method, however, may not be used for any taxable year that begins prior to the date that the Treasury Department publishes regulations that authorize the use of the simplified method and set forth the requirements that must be satisfied in order for the method to be used.

C. Minimum Tax Provisions

1. Depreciation under the corporate alternative minimum tax (sec. 421 of the bill and sec. 56 of the Code)

Present Law

Under present law, a corporation is subject to an alternative minimum tax (AMT) which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. Alternative minimum taxable income (AMTI) is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments which is made to taxable income to arrive at AMTI relates to depreciation. Depreciation on personal property to which the modified ACRS system adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the life described in Code section 168(g) (generally the ADR life of the property).

For taxable years beginning after 1989, AMTI is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) exceed AMTI (as determined before this adjustment). In general, ACE means AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT--once using the 150 percent declining balance method and again using the straight-line method. Taxpayers may elect to use either depreciation method for regular tax purposes. If a taxpayer uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Reasons for Simplification

The use of two separate depreciation systems complicates the calculation of, and the recordkeeping for, the corporate alternative minimum tax.

Explanation of Provision

The bill applies a 120-percent declining balance method (switching to straight-line at a point maximizing depreciation deductions) for personal property (other than transition property to which the ACRS system in effect before the Tax Reform Act of 1986 applies) for determining the AMTI of a corporation. No further depreciation adjustment for this property would be required for ACE. Thus, corporations would be required to keep only one set of depreciation records for purposes of the AMT.

Corporate taxpayers may elect to use the 120-percent declining balance method of depreciation for regular tax purposes. As under present law, if a corporation uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Effective Date

The provision is effective for property placed in service in taxable years beginning after December 31, 1990.

2. Treatment of built-in losses for purposes of the corporate alternative minimum tax (sec. 422 of the bill and sec. 56(g) of the Code)

Present Law

For purposes of the regular corporate tax, if at the time of an ownership change, a corporation has a net operating loss or a net unrealized built-in loss, the use of such losses in post-change periods is limited. A corporation has a net unrealized built-in loss if the aggregate adjusted bases of the assets of the corporation exceed the fair market value of the assets immediately before the change of ownership (sec. 382).

For purposes of the adjusted current earnings (ACE) component of the corporate alternative minimum tax (AMT), if a corporation with a net unrealized built-in loss undergoes an ownership change in a taxable year beginning after 1989, the adjusted basis of each asset of such corporation generally is adjusted to each asset's fair market value (sec. 56(g)(4)(G)). This rule essentially eliminates, rather than limits, the use of built-in losses for ACE purposes. The net operating loss of a corporation, on the other hand, is not eliminated for AMT purposes after a change of ownership.

Reasons for Simplification

Present law complicates the treatment of built-in losses of a corporation after a change of ownership by providing different rules for regular and alternative minimum tax and by providing rules different than those applicable to net operating losses. The present-law alternative minimum tax rules applicable to built-in losses requires a significant amount of additional recordkeeping.

Description of Provision

The bill repeals the ACE rule relating to the treatment of built-in losses after a change of ownership. Thus, for ACE purposes, the treatment of built-in losses would be similar to the treatment of net operating loss carryovers (in the same way that the treatment of built-in losses is similar to the treatment of net operating losses for regular tax purposes).

Effective Date

The provision is effective for changes of ownership occurring after December 31, 1991.

D. Tax-Exempt Bond Provisions

1. Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of the issuing governmental units (sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for a private party (or private parties) in a manner violating either (a) a private business use and payment test or (b) a private loan restriction. However, interest on private activity bonds generally is not taxable if (a) the financed activity is specified in the Code, (b) at least 95 percent of the net proceeds of the bond issue are used to finance the specified activity, and (c) numerous other requirements, including annual State volume limitations (for most private activity bonds) are satisfied.

Both private activity bonds and governmental bonds also must satisfy arbitrage restriction requirements for interest to be excluded from gross income. Interest on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item under the individual and corporate alternative minimum taxes. Additionally, interest on all State and local government bonds is included in determining a corporation's adjusted current earnings preference.

2. Issues under continuing review

It is expected that Congress will continue to review as the subject of possible legislative projects additional simplification options in two areas affecting State and local government bonds. These issues are--

a. Possible statutory rules for use by governmental units maintaining non-arbitrage motivated commingled accounting practices in determining their arbitrage rebate liability; and

b. Possible penalty alternatives to loss of tax-exemption for selected violations of the rules governing qualification for tax-exemption.

3. Provisions of the bill

a. Simplification of arbitrage rebate requirement for governmental bonds (sec. 431 of the bill and sec. 148 of Code)

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Reasons for Simplification

The principal Federal policy concern underlying the arbitrage rebate requirement is the earlier and larger than necessary issuance of tax-exempt bonds to take advantage of the opportunity to profit by investing funds borrowed at low-cost tax-exempt rates in higher yielding taxable investments. If at least 95 percent of the proceeds of an issue are spent within six months, and the remainder within one year, opportunities for arbitrage profit are significantly limited. In the case of larger issues, the administrative complexity of calculating rebate liability on relatively small amounts of proceeds, e.g., $100,000 of proceeds, is greater than the potential for arbitrage abuse from eliminating the rebate requirement.

Explanation of Provision

The bill deletes the $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement. Thus, if at least 95 percent of the proceeds of these bonds is spent within six months after the issuance, and the remainder is spent within one year, the six-month exception is deemed to be satisfied.

Effective Date

This provision applies to bonds issued after the date of enactment.

b. Simplification of compliance with 24-month arbitrage rebate exception for construction bonds (sec. 432 of the bill and sec. 148 of the Code)

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally owned property.

The exception is satisfied only if the available construction proceeds of the issue are spent at least at specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund or a bona fide debt service fund or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating if they fail to satisfy the exception's spending requirements.

Reasons for Simplification

Bond proceeds invested in a bona fide debt service fund generally must be spent at least annually for current debt service. The short-term nature of investments in such funds results in only limited potential for generating arbitrage profits. If the spending requirements of the 24-month rebate exception are satisfied, the administrative complexity of calculating rebate on these proceeds outweighs the other Federal policy concerns addressed by the rebate requirement. Further, this provision will conform the rules on these funds for issuers satisfying the six-month and 24-month expenditure exceptions to the rebate requirement.

Explanation of Provision

The bill exempts earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the spending and penalty requirements of the 24-month exception if the spending requirements of that exception are satisfied.

Effective Date

This provision applies to bonds issued after the date of enactment.

c. Automatic extension of initial temporary period for certain construction bonds (sec. 433 of the bill and sec. 148 of the Code)

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of arbitrage requirements with respect to investment of their bond proceeds. First, tax-exempt bond proceeds may not be invested at a yield materially higher (generally defined as 0.125 percentage points) than the bond yield. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Second, generally all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. Arbitrage profits generally include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Simplification

Notwithstanding the arbitrage rebate requirement, requiring yield restriction following initial temporary periods is an important factor in curbing earlier issuance of bonds than otherwise would occur. Provided that issuers substantially comply with a prompt expenditure requirement so that the opportunities for tax motivated arbitrage are limited, however, reliance on the rebate requirement for limited additional periods will allow issuers to continue to pursue more flexible and liquid investments while construction activities are being completed. Automatically allowing an additional 12-month period, where substantially all of the proceeds have been spent, will relieve issuers from the burden of seeking a ruling from the IRS without increasing the opportunity for arbitrage motivated investments.

Explanation of Provision

The bill provides that the initial temporary period for construction bonds is automatically extended for a period of 12 months if at least 85 percent of the available construction proceeds are spent within the original initial temporary period and the issuer reasonably expects to spend the remaining proceeds within the 12-month extension period. Construction bonds eligible for this automatic extension include only those bonds currently eligible for the 24-month rebate expenditure exception, described above.

The bill allows bond proceeds to be invested without yield restriction during this additional period. The arbitrage rebate or 1.5-percent penalty requirement will continue to apply to unspent proceeds during the extension period.

Effective Date

This provision applies to bonds issued after the date of enactment.

d. Simultaneous issuance of certain discrete issues not aggregated (sec. 434 of the bill)

Present Law

In certain cases, the Treasury Department treats multiple issues of tax-exempt bonds paid from substantially the same source of funds as a single issue in applying the Code's tax-exempt bond restrictions when the bonds are issued within a relatively short period of time (31 days) and pursuant to a common plan of marketing.

Reasons for Simplification

Requiring issuers that simultaneously issue discrete issues of tax and revenue anticipation notes ("TRANs") and other governmental bonds to separate issuance of discrete non-arbitrage motivated issues by 31 days adds administrative complexity and increases their costs of issuance.

Explanation of Provision

The bill provides that discrete issues of governmental bonds issued simultaneously will not be treated as a single issue in cases where one of the issues is a TRAN reasonably expected to satisfy the arbitrage rebate safe harbor of section 148(f)(4)(B)(iii).

Effective Date

This provision applies to bonds issued after the date of enactment.

e. Authority for Treasury Department to exempt certain taxpayers from tax-exempt interest reporting requirement (sec. 435 of the bill and sec. 6012 of the Code)

Present Law

Present law requires all individuals to report on their income tax returns the amount of interest on State and local government bond interest they receive.

Reasons for Simplification

The Internal Revenue Service should be authorized to exempt taxpayers from requirements to compile and report information on income tax returns if the Secretary determines that such information is not useful to the administration of the tax laws.

Explanation of Provision

The bill authorizes the Internal Revenue Service to provide exceptions from the requirement that taxpayers report interest on State and local government bonds on their Federal income tax returns in cases where the Secretary determines that such information is not useful to the administration of the tax laws.

Effective Date

This provision is effective for taxable years beginning after the date of enactment.

f. Repeal of deadwood provisions (sec. 436 of the bill and sec. 148 of the Code)

Present Law

Present law includes special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. This exception applied only to bonds issued before January 1, 1989.

Explanation of Provision

The bill deletes these special exceptions as "deadwood."

Effective Date

This provision applies to bonds issued after the date of enactment.

E. Treatment of Certain Revocable Trusts as Estates (sec. 441 of the bill and sec. 7701 of the Code)

Present Law

A grantor trust is treated as owned by the grantor, who is taxed on its income and is entitled to its deductions. A grantor trust includes a revocable trust, one in which the grantor retains the power to revest the title of the trust property in himself (sec. 676).

Trusts and estates are subject to different income tax rules. An estate receives a higher exemption (sec. 642(b)) and is allowed a deduction for amounts permanently set aside for charity (sec. 642(c)), and, for two years after the decedents death, a $25,000 offset for rental real estate activities (sec. 469(i)). A trust is required to adopt a calendar year (sec. 645(a)), and a distribution from a trust in the first 65 days of the taxable year is treated as occurring on the last day of the preceding taxable year (sec. 663(b)) (the "65-day rule").

Trusts and estates generally are required to pay estimated taxes in the same manner as individuals. A special rule exempts estates from estimated taxes for taxable years ending within two years of the decedent's death. This exemption also applies to a grantor trust that either receives the residue of the probate estate under the grantor's will, or, (if there is no will) is primarily responsible for paying taxes, debts and expenses of administration.

Reasons for Simplification

Estate planners commonly use revocable trusts to avoid probate. Creating parity between such trusts and estates simplifies planning by reducing the role of tax considerations in the decision to utilize revocable trusts.

Explanation of Provision

The bill treats as an estate a revocable trust receiving the residue of the probate estate under the grantor's will. If there is no will, the revocable trust that is primarily responsible for paying taxes, debts and expenses of administration is treated as an estate. Such treatments apply only for years ending after the decedent's death and beginning within three years, nine months of the decedent's death. As a conforming amendment, the bill limits the rule treating grantor trusts as estates for purpose of estimated taxes to grantor trusts described in section 676.

The provision generally applies for all income tax purposes. It thus allows a revocable trust a deduction for an amount set aside for charity and the $25,000 offset for rental real estate activities to the extent the offset is not utilized by the estate. It denies such trust the benefit of the 65-day rule. The provision does not apply for transfer tax purposes.

The provision does not apply for purposes of determining the amount of personal exemption, the taxable year or any other purpose specified in regulations. Thus, as under present law, revocable trusts will continue to receive a lower exemption amount and be required to adopt a calendar year. It is anticipated that the Treasury Department may exercise its regulatory authority in other situations to require consistency with prior tax treatment or to maintain parity with decedents having an estate but no revocable trust.

Effective Date

The provision applies to decedents dying after the date of enactment.

F. Other Provisions Relating to Partnerships

1. Matching rules for payments to partners (sec. 442 of the bill and secs. 267, 706 and 707 of the Code)

Present Law

If a partner engages in a transaction with a partnership other than in a capacity as a member of the partnership, the transaction is considered as occurring between the partnership and one who is not a partner. Under the timing rule applicable to such transactions (and to transactions among related persons generally), payments made to one who is not treated as a partner are deductible by the partnership in the year in which they are includible in the recipient's income. A partner generally is treated as acting in a capacity other than as a partner to the extent that his income from the transaction with the partnership does not depend upon partnership profit.

Payments to a partner for services or the use of capital that are determined without regard to partnership income ("guaranteed payments") are for specified purposes considered as made to one who is not a member of the partnership. Under the timing rule applicable to guaranteed payments, such payments generally are includible in the partner's income in the year in which they are deductible by the partnership.

Reasons for Simplification

Many payments to a partner can be described as either made to a person in a capacity other than as a partner or as guaranteed payments. The existence of two different timing rules creates uncertainty as to the proper tax treatment. By conforming the timing rule for guaranteed payments to the timing rule generally applicable to transactions among related parties, the provision reduces uncertainty and eliminates a potential issue of controversy.

Explanation of Provision

The bill defers the deduction of guaranteed payments by a partnership until the year in which they are includible in the partner's income. Thus, the bill conforms the timing rule for guaranteed payments to the timing rule for payments made to a partner acting in a capacity other than as a member of the partnership.

Effective Date

The bill applies to amounts taken into account after date of enactment.

2. Close partnership taxable year with respect to deceased partner (sec. 443 of the bill and sec. 706(c) of the Code)

Present Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year that includes his death is taxed to his estate or successor in interest rather than being reported on the decedent's final income tax return. (See *Estate of Hesse v. Commissioner*, 74 T.C. 1307, 1311 (1980).)

Reasons for Simplification

The rule leaving open the partnership taxable year with respect to a deceased partner was adopted in 1954 to prevent the bunching of income that could occur with respect to a partnership reporting on a fiscal year other than the calendar year. Without this rule, as many as 23 months of income might have been reported on the partner's final return. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, reducing the possibility of bunching. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partner's death and partnership items are reported on the decedent's last return.

Present law closes the partnership taxable year with respect to a deceased partner only if the partner's entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the proposal reduces the need for such agreements.

Explanation of Provision

The bill provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1991.

G. Corporate Provision: Clarification of Amount of Gain Recognized by a Securityholder in a Reorganization, Etc. (sec. 444 of the bill and secs. 354-356 of the Code)

Present Law

Under present law, gain is recognized by a shareholder or securityholder in a reorganization (or distribution under sec. 355) only to the extent property other than stock or securities of the corporation or of a party to the reorganization are received. For purposes of this rule, the fair market value of the excess of the principal amount of any securities received over the principal amount of any securities surrendered is treated as other property. If the principal amount of the securities received and the principal amount of the securities surrendered is the same, no amount of the securities received is treated as other property.

Also, under present law, a certain portion of the stated redemption price at maturity of a security may be treated as treated as interest (referred to as "original issue discount" or "OID"), rather than principal. Also, in certain limited circumstances, a portion of a payment designated as principal may be treated as interest (under sec. 483).

It is unclear under present law whether the OID rules apply for purposes of determining the principal amount of a security for purposes of the nonrecognition rules described above.

Reasons for Simplification

The provision promotes simplification by conforming the rules for determining gain where securities are exchanged in a corporate reorganization with other rules in the Code allocating amounts in a debt instrument between principal and interest.

Explanation of Provision

The bill provides that for purposes of determining the amount of gain recognized to a securityholder in a reorganization (or a sec. 355 distribution), the excess of the issue price (as defined in secs. 1273 and 1274) of the securities received over the adjusted issue price of the securities surrendered would be treated as other property. If securities are received and none surrendered, the entire issue price is treated as other property. If the issue price of the securities received does not exceed the adjusted issue price of the securities surrendered, then no amount of the securities is treated as other property. These rules apply both to securityholders using the cash method and the accural method of accounting.

The adjusted issue price of a security surrendered means the issue price of the security, increased by the OID previously included in the gross income of any holder of the security (determined without to the special rule for subsequent holders), or decreased by the amount of bond premium which would have been allowed as a deduction (or offset) if the bond had always been held by the original holder. Where section 1273(b)(4) applies to a security, the stated redemption price is reduced by the amount of the redemption price which is treated as interest (for example, under sec. 483).

The provision is not intended to create any inference as to the proper treatment of these transactions under present law.

The following examples illustrate the application of this provision:

Example (1).--Assume that a publicly traded security with a stated principal amount of $1,000 and a fair market value of $800 is issued by a corporation in a reorganization to a security holder in exchange for a security with a stated principal amount of $600 and an adjusted issue price of $500. Under the bill, the amount of the excess issue price, or $300, is treated as "other property" for purposes of section 356.

Example (2).--Assume that a publicly traded security with a stated principal amount of $1,000 and a fair market value of $1,200 is issued by a corporation in a reorganization to a security holder in exchange for a security with a stated principal amount and an adjusted issue price of $1,000. Under the bill, the amount of the excess issue price, or $200 is treated as "other property" for purposes of section 356.

Effective Date

The provision applies to exchanges and distributions after the date of enactment.

Title V.--Provisions Relating to Estate and Gift Taxation

1. Waiver of right of recovery for certain marital deduction property (sec. 501 of the bill and sec. 2207A of the Code)

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to such inclusion from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). A will requiring that all taxes be paid by the estate may, under State law, waive the right of recovery.

The gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Reasons for Simplification

It is understood that persons utilizing standard testamentary language often inadvertently waive the right of recovery with respect to QTIP. Allowing the right of recovery to be waived only by specific reference simplifies the drafting of wills to better conform with the testator's likely intent.

Explanation of Provision

The bill conforms the rule governing waiver of the right to contribution for QTIP to the rule governing waiver of the right of recovery for property includable under section 2036. Accordingly, the surviving spouse's estate has a right of recovery with respect to QTIP unless the spouse otherwise directs in a provision of the will (or revocable trust) specifically referring to section 2207A.

Effective Date

The provision applies to decedents dying after the date of enactment.

2. Inclusion in gross estate of certain gifts made within three years of death (sec. 502 of the bill and secs. 2035 and 2038 of the Code)

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). It also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). This rule has been interpreted to include in the gross estate certain transfers made from a revocable trust within three years of death.[36] Such inclusion subjects gifts that would otherwise qualify under the annual $10,000 exclusion to estate tax.

Reasons for Simplification

The inclusion of certain property transferred during the three years before death is intended to address situations in which such transfer would otherwise reduce the value of property subject to transfer tax. Inclusion is unnecessary if the entire value of the underlying property is subject to gift tax and the transferor has retained no powers over such property. Repeal of such inclusion eliminates a principal tax disadvantage of funded revocable trusts, which are generally used for nontax purposes.

Explanation of Provision

The bill provides that a transfer from a revocable trust within three years of death does not result in the inclusion of the transfer in the gross estate. It is intended that no inference be drawn from the provision with respect to the treatment of transfers from revocable trusts under present law.

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[36] See, e.g., Jalkut Estate v. Commissioner. 96 T.C. No. 27 (April 29, 1991) (transfers from revocable trust to permissible beneficiaries of the trust includible in the grantor's gross estate); LTR 9117003 (same).

The bill also revises section 2035 to improve its clarity.

Effective Date

The provision applies to decedents dying after the date of enactment.

3. Definition of qualified terminable interest property (sec. 503 of the bill and secs. 2044, 2056(b)(7), and 2523(f) of the Code)

Present Law

A marital deduction is allowed for qualified terminable interest property (QTIP). Property is QTIP only if the surviving spouse has a qualifying income interest for life (e.g., the spouse is entitled to all of the income from the property, payable at least annually). QTIP generally is includible in the surviving spouse's gross estate.

Under proposed regulations, an income interest may constitute a qualifying income interest for life even if income between the last distribution date and the date of the surviving spouse's death (the "accumulated income") is not required to be distributed to the surviving spouse or the surviving spouse's estate. (See Prop. Reg. secs. 20.2056(b)-7(c)(1), 25.2523(f)-1(b)). Contrary to the regulations, the United States Tax Court has held that in order to satisfy the QTIP requirements, the accumulated income must be paid to the spouse's estate or be subject to a power of appointment held by the spouse. (See *Estate of Howard v. Commissioner*, 91 T.C. 329, 338 (1988), *rev'd*, 910 F.2d 633 (9th Cir. 1990)).

Reasons for Simplification

The Tax Court opinion in *Estate of Howard* has created uncertainty as to when a trust qualifies for the marital deduction. This uncertainty makes planning difficult and necessitates closing agreements designed to prevent the whipsaw that would occur if a deduction is allowed for property that is not subsequently included in the spouse's estate. By codifying the Treasury Regulations, the bill eliminates uncertainty and simplifies the administration of the tax laws.

Explanation of Provision

Under the bill, an income interest does not fail to be a qualified income interest for life solely because the accumulated income is not required to be distributed to the surviving spouse. When the marital deduction is allowed, however, such income is includible in the surviving spouse's gross estate.

It is intended that no inference be drawn from the provision with respect to the definition of a qualified income interest for life under present law.

Effective Date

The provision applies to decedents dying, and gifts made, after date of enactment. The proposal does not include in the surviving spouse's gross estate property for which no marital deduction was claimed.

4. Requirements for qualified domestic trust (sec. 504 of the bill and sec. 2056A of the Code)

Present Law

A deduction generally is allowed for Federal estate tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust (QDT). An estate tax is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust, which, among other things, required that all trustees be U.S. citizens or domestic corporations. This requirement was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to provide that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Reasons for Simplification

Wills drafted under the TAMRA rules must be revised to conform with the withholding requirement, even though both the TAMRA rule and its successor ensure that a U.S. trustee is personally liable for the estate tax on a QDT. By reducing the number of will revisions necessary to comply with the statutory changes, the provision simplifies estate planning.

Explanation of Provision

A trust created before the enactment of the Omnibus Budget Reconciliation Act of 1990 is treated as satisfying the withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations.

Effective Date

The provision applies as if included in the Omnibus Budget Reconciliation Act of 1990.

5. Election of special use valuation of farm property for estate tax purposes (sec. 505 of the bill and sec. 2032A of the Code)

Present Law

An executor may elect to value certain real property used in farming or other closely held business operations for estate tax purposes based upon its current use value rather than its full fair market value (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury Department regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A-8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Secretary of the Treasury, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property is allowed to supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Secretary.

Reasons for Simplification

In filing the estate tax return, executors commonly neglect to include a recapture agreement signed by all persons with an interest in the property or all information required by Treasury regulations. Allowing such signatures or information to be supplied later simplifies return filing.

Explanation of Provision

The bill extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to his compliance with the regulations. Thus, the bill allows the current use valuation election to any such executor who supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. The bill also allows signatures to be added to the previously filed agreement during that time period.

Effective Date

The provision applies to decedents dying after the date of enactment.

Title VI.--Excise Tax Provisions

A. Motor Fuel Excise Tax Provisions

1. Consolidate provisions imposing diesel and aviation fuel excise taxes (sec. 601 of the bill and secs. 4041 and 4091 of the Code)

Present Law

Code section 4091 imposes a tax on the sale of diesel and aviation fuel by a "producer." The term producer generally includes refiners, compounders, blenders, and wholesalers who are registered with the Internal Revenue Service. The term also includes persons to whom diesel or aviation fuel has been sold tax-free.

As a backup, Code section 4041 imposes a tax on certain sales or uses of diesel and aviation fuel if a taxable sale of such fuel has not occurred under section 4091.

Reasons for Simplification

Consolidating the diesel and aviation tax rules into one section of the Code will make the rules easier to find and understand.

Explanation of Provision

The bill combines the diesel and aviation fuel tax provisions currently divided between Code sections 4041 and 4091 into a revised section 4091. The use of diesel and aviation fuel in a taxable use by producers will be taxed under section 4091, and the definition of producer is clarified to include purchasers in tax-reduced sales.

The bill also simplifies the Code by eliminating two unnecessary provisions, sections 4041(b)(1)(B) and (j) of the Code. These provisions are redundant.

Effective Date

The provision is effective for sales or uses on or after January 1, 1992.

2. Permit refund of tax to taxpayer for diesel and aviation fuel resold to certain exempt purchasers (sec. 602(a) of the bill and sec. 6416(b) of the Code)

Present Law

As a general matter, purchasers who use tax-paid fuels for an exempt use are entitled to a refund or credit. Purchasers of tax-paid fuels generally are not permitted a refund or credit if they resell the fuels to another person who subsequently uses them in an exempt use.

However, persons who buy and then resell fuel subject to the special motor fuel or gasoline taxes and of certain other articles are permitted a refund or credit (rather than the ultimate user) if they resell the fuel or article for use in the following exempt uses: (1) export, (2) use as supplies for aircraft or vessels, (3) use by a State or local government, or (4) use by a nonprofit educational organization for its exclusive use.

Reasons for Simplification

Diesel and aviation fuel sales are not subject to the special refund or credit procedures, which forces users of such fuels for exempt purposes to bear the burden of filing for the refund or credit themselves and, therefore, makes such purchases more difficult.

Explanation of Provision

The bill allows a refund or credit to taxpayers for diesel and aviation fuel sold tax-paid to persons who resell for any of the exempt uses described above.

Effective Date

The provision is effective for sales on or after January 1, 1992.

3. Consolidate refund provisions for fuel excise taxes (sec. 602(b) of the bill and secs. 6420, 6421, and 6427 of the Code)

Present Law

As a general matter, purchasers who use fuels for an exempt use are entitled to a refund if the fuels have been purchased tax-paid. The refund provisions for the fuels excise taxes are found in several sections of the Code.

In general, a purchaser entitled to a refund may file a quarterly refund claim for any of the first three quarters of the purchaser's tax year, if the claim exceeds a threshold dollar amount (with the lowest being $750). The threshold amounts differ for different fuels and different exempt uses and whether quantities are aggregated. A purchaser cannot file a quarterly claim for refund for its fourth quarter, but must file the claim as a credit on that year's income tax return.

There is an expedited procedure for gasohol blenders claiming a refund of part of the excise tax included in the price of the gasoline used for blending into gasohol.

Finally, only an income tax credit, and not a refund, may be claimed for excise taxes on gasoline and special motor fuel used on a farm for farming purposes.

Reasons for Simplification

Consolidating the credit and refund provisions for fuel excise taxes into one section in the Code will make these provisions easier to find and understand. Standardizing the refund procedures will reduce confusion and allow taxpayers to obtain refunds more quickly.

Explanation of Provision

The bill consolidates the user credit and refund provisions for the fuels excise taxes into one section of the Code. The bill also combines the three refund procedures for fuels taxes into a uniform refund procedure. The new uniform refund procedure permits an exempt user to aggregate its refund claims for all fuels taxes and file for a refund in any calendar quarter in which the amount of the aggregate claim exceeds $750. The uniform refund procedure also permits such a user to file for a refund for its fourth quarter rather than apply for a credit.

The special expedited procedure for gasohol blenders is unchanged.

Effective Date

The provision is effective for sales on or after January 1, 1992.

4. Repeal waiver requirement for fuel tax refunds for cropdusters and other fertilizer applicators (sec. 602(b) of the bill and sec. 6420 of the Code)

Present Law

In general, farmers who use gasoline and aviation fuel on a farm are entitled to a refund of the tax that has been paid on that fuel. Cropdusters and other fertilizer applicators that use gasoline and aviation fuel on a farm are entitled to a refund of the tax paid on that fuel in lieu of the farmer, but only if the owner or operator of the farm waives its right to a refund for such fuel.

Reasons for Simplification

Eliminating the waiver will reduce the paperwork burden of a taxpayer seeking a refund.

Explanation of Provision

The bill eliminates the waiver requirement for fuels tax refunds for cropdusters and other fertilizer applicators.

Effective Date

The provision is effective for fuels purchased on or after January 1, 1992.

5. Authorize exceptions from information reporting for certain sales of diesel and aviation fuel (sec. 603 of the bill and sec. 4093(c)(4) of the Code)

Present Law

Certain producers and importers and purchasers are required to file information returns for reduced-tax sales of diesel and aviation fuel.

Reasons for Simplification

Allowing the Internal Revenue Service to exempt certain classes of taxpayers will simplify the IRS' administration of the registration requirements and eliminate unnecessary paperwork for taxpayers.

Explanation of Provision

The bill permits the IRS by regulation to provide exceptions to the mandatory information return requirement for certain sales of diesel and aviation fuel.

Effective Date

The provision applies to sales on or after January 1, 1992.

B. Provisions Relating to Distilled Spirits, Wines, and Beer (secs. 611-621 of the bill, secs. 5008(c), 5044, 5053, 5055, 5115, 5175(c), 5207(c), 5222(b), 5384(b) of the Code, and new sec. 5418 of the Code)

Present Law

Return of imported bottled distilled spirits

Present law provides that when tax-paid distilled spirits which have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise taxes are refunded (sec. 5008(c)). This provision does not apply to imported bottled distilled spirits, since they are withdrawn from customs custody and not from bonded premises.

Bond for exported distilled spirits

Bond generally must be furnished to the Department of the Treasury when distilled spirits are removed from bonded premises for exportation without payment of tax. These bonds are cancelled or credited when evidence is submitted to the Department of the Treasury that the distilled spirits have been exported (sec. 5175(c)).

Distilled spirits plant records

Distilled spirits plant proprietors are required to maintain records of their production, storage, denaturation, and other processing activities on the premises where the operations covered by the records are carried on (sec. 5207(c)).

Transfers from breweries to distilled spirits plants

Under present law, beer may be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, but only if the brewery is contiguous to the distilled spirits plant (sec. 5222(b)).

Posting of sign by wholesale liquor dealers

Wholesale liquor dealers (i.e., dealers, other than wholesale dealers in beer alone, who sell distilled spirits, wines, or beer to other persons who re-sell such products) are required to post a sign conspicuously on the outside of their place of business indicating that they are wholesale liquor dealers (sec. 5115).

Refund of tax for wine returned to bond

Under present law, when unmerchantable wine is returned to bonded production premises, tax that has been paid is returned or credited to the proprietor of the bonded wine cellar to which the wine is delivered (sec. 5044). In contrast, when beer is returned to a brewery, tax that has been paid is returned or credited, regardless of whether the beer is unmerchantable (sec. 5056(a)).

Use of ameliorating material in certain wines

The Code contains rules governing the extent to which ameliorating material (e.g., sugar) may be added to wines made from high acid fruits and the product still be labelled as a standard, natural wine. In general, ameliorating material may not exceed 35 percent of the volume of juice and ameliorating material combined (sec. 5383(b)(1)). However, wines made exclusively from loganberries, currants, or gooseberries are permitted a volume of ameliorating material of up to 60 percent (sec. 5384(b)(2)(D)).

Domestically produced beer for use by foreign embassies, etc.

Under present law, domestically produced distilled spirits and wine may be removed from bond, without payment of tax, for transfer to any customs bonded warehouse for storage pending removal for the official or family use of representatives of foreign governments or public international organizations (secs. 5066 and 5362(e)). (A similar rule also applies to imported distilled spirits, wine, and beer.) No such provision exists under present law for domestically produced beer.

Withdrawal of beer for destruction

Present law does not specifically permit beer to be removed from a brewery for destruction without payment of tax.

Records of exportation of beer

Present law provides that a brewer is allowed a refund of tax paid on exported beer upon submission to Department of the Treasury of certain records indicating that the beer has been exported (sec. 5055).

Transfer to brewery of beer imported in bulk

Imported beer brought into the United States in bulk containers may not be transferred from customs custody to brewery premises without payment of tax. Under certain circumstances, distilled spirits imported into the United States in bulk containers may be transferred from customs custody to bonded premises of a distilled spirits plant without payment of tax (sec. 5232).

Reasons for Simplification

In addition to imposing taxes, the Internal Revenue Code regulates many aspects of the alcoholic beverage industry. These regulations date in many cases from the prohibition era or earlier. In 1980, the method of collecting excise taxes on alcoholic beverages was changed from a system under which Treasury Department inspectors regularly were present at production facilities to a bonded premises system, which more closely tracks the systems used in connection with other Federal taxes. Many of the recordkeeping requirements and other regulatory measures imposed in connection with these taxes have not been modified to conform to these collection changes. In addition, modification of statutory provisions is warranted in view of advances in technology used in the alcoholic beverage industry and environmental protection concerns.

Explanation of Provisions

Return of imported bottled distilled spirits

The procedures for refunds of tax collected on imported bottled distilled spirits returned to bonded premises are conformed to the rules for domestically produced and imported bulk distilled spirits. Thus, refunds are available for all distilled spirits on their return to a bonded distilled spirits plant.

Bond for exported distilled spirits

For purposes of cancelling or crediting bonds furnished when distilled spirits are removed from bonded premises for exportation, the Department of the Treasury is authorized to permit records of exportation to be maintained by the exporter, rather than requiring submission to it of proof of exportation in all cases.

Distilled spirits plant records

Distilled spirits plant proprietors are permitted to maintain records of their activities at locations other than the premises where the operations covered by the records are carried on (e.g., corporate headquarters), provided that the records are available for inspection by the Treasury Department during business hours.

Transfers from breweries to distilled spirits plants

The bill allows beer to be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, regardless of whether the brewery is contiguous to the distilled spirits plant.

Posting of sign by wholesale liquor dealers

The requirement that wholesale liquor dealers post a sign outside their place of business indicating that they are wholesale liquor dealers is repealed.

Refund of tax for wine returned to bond

The bill deletes the requirement that wine returned to bonded premises be "unmerchantable" in order for tax to be refunded to the proprietor of the bonded wine cellar to which the wine is delivered.

Use of ameliorating material in certain wines

The wine labelling restrictions are modified to allow any wine made exclusively from a fruit or berry with a natural fixed acid of 20 parts per thousand or more (before any correction of such fruit or berry) to contain a volume of ameliorating material not in excess of 60 percent.

Domestically produced beer for use by foreign embassies, etc.

The bill extends to domestically produced beer the present-law rule applicable to domestically produced distilled spirits and wine (and imported distilled spirits, wine, and beer) which permits these products to be withdrawn from the place of production without payment of tax for the official or family use of representatives of foreign governments or public international organizations.

Withdrawal of beer for destruction

The bill allows beer to be removed from a brewery without payment of tax for purposes of destruction, subject to Treasury Department regulations.

Records of exportation of beer

The bill repeals the requirement that proof of exportation be submitted to the Treasury Department in all cases as a condition of receiving a refund of tax. This proof will continue to be required to be maintained at the exporter's place of business.

Transfer to brewery of beer imported in bulk

The bill extends the present-law rule applicable to distilled spirits imported into the United States in bulk containers to beer imported into the United States in bulk containers, so that imported beer may, subject to Treasury regulations, be withdrawn from customs custody for transfer to a brewery without payment of tax.

Effective Date

These provisions of the bill generally are effective beginning 180 days after date of the bill's enactment. The provision deleting the requirement that wholesale liquor dealers post a sign outside their place of business is effective on the date of the bill's enactment.

C. Other Excise Tax Provisions

1. Authority for IRS to grant exemptions from registration requirements (sec. 631 of the bill and sec. 4222 of the Code)

Present Law

Under section 4222, certain sales of articles subject to Federal excise taxes may not be made without payment of tax under section 4121 unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under regulations prescribed by the Secretary.

Reasons for Simplification

Allowing the Internal Revenue Service to exempt certain classes of taxpayers from the registration requirements will simplify the Service's administration of the registration provisions. Also, the provision will reduce unnecessary paperwork for affected taxpayers.

Explanation of Provision

The bill revises section 4222(a) so that certain sales of articles subject to Federal excise taxes may not be made without payment of tax under section 4221 to any person who is required by the Secretary to be registered but who is not so registered. This will allow the Secretary to provide exemption from registration requirements for certain classes of taxpayers.

Effective Date

The provision applies to sales after the 180th day after the date of enactment.

2. Repeal temporary reduction in tax on piggyback trailers (sec. 632(a) of the bill and sec. 4051(d) of the Code)

Present Law

Piggyback trailers and semitrailers sold within the 1-year period beginning on July 18, 1984 were permitted a temporary reduction in the retail excise tax on trailers.

Explanation of Provision

The bill repeals the temporary reduction in tax on piggyback trailers as "deadwood."

Effective Date

The provision is effective on the date of enactment.

3. Expiration of excise tax on deep seabed minerals (sec. 632(b) of the bill and secs. 4495-4498 of the Code)

Present Law

Background

The Deep Seabed Mineral Resources Act (the "Resources Act," P.L. 96-283), one title of which was the Deep Seabed Hard Mineral Removal Tax Act of 1979 (the "Tax Act"), was enacted into law on June 28, 1980. The Resources Act was intended to encourage the successful negotiation of an international deep seabed treaty by the United Nations Conference on the Law of the Sea (a U.N. international deep seabed treaty), and pending the entry into force of such a treaty, to establish a special fund to support international revenue sharing from deep seabed mineral recovery. To this end, the Act established an interim trust fund in the Treasury, the Deep Seabed Revenue Sharing Trust Fund (the Trust Fund), into which any Tax Act receipts would be deposited. There have been no tax collections under the Tax Act. The Trust Fund proceeds were intended to be used to help discharge any U.S. financial obligations under a U.N. international deep seabed treaty should the United States become a party thereto.

Subsequent to the enactment of the Resources Act, the U.N. Conference on the Law of the Sea completed negotiations for an international deep seabed treaty in 1982, and the United States announced that it would not sign the treaty.

If and when the Law of the Sea Convention (the Convention) enters into force, it would establish a regime for the regulation of mineral extraction from the deep seabed, and would impose revenue obligations on its adherents. Such obligations were to be fundable by the Deep Seabed Revenue Trust Fund, if the United States were to become obligated by the Convention.

Excise tax on certain hard minerals

The Tax Act added sections 4495 through 4498 to the Internal Revenue Code. These sections would impose an excise tax on the removal from the deep seabed of certain hard mineral resources pursuant to a deep seabed permit issued under the Resources Act. In general, a deep seabed permit issued under the Resources Act would authorize its holder to engage in commercial recovery activities with respect to hard mineral resources on or under deep seabeds. No such permits have been issued.

Deep seabeds are, in general, areas outside the continental shelf of any nation. In general, hard mineral resources are mineral nodules, lying on or just below the surface of deep seabeds, that contain one or more minerals including manganese, nickel, cobalt, or copper. Under the Tax Act, if a person removes a hard mineral resource from the deep seabed pursuant to a deep seabed permit, a tax is imposed on the permit holder equal to 3.75 percent of 20 percent (or 0.75 percent) of the fair market value of the commercially recoverable minerals removed.

The Tax Act was scheduled to terminate on the earlier of the date on which a U.N. international deep seabed treaty took effect with respect to the United States, or June 28, 1990 (10 years after the date of enactment of the Tax Act). Since the United States did not sign the treaty, the excise tax provisions expired on June 28, 1990.

Explanation of Provision

The bill deletes the deep seabed hard minerals excise tax provisions as "deadwood."

Effective Date

The provision is effective on the date of enactment.

Title VII.--Administrative Provisions

A. Administrative Provisions

1. Simplify employment tax reporting for household employees (sec. 701 of the bill and secs. 3102, 3121, 3306 and 6654 of the Code)

Present Law

An employer who pays a household employee wages of $50 or more in a calendar quarter for household work must withhold social security taxes (including medicare taxes) from wages paid to the employee during the quarter. The employer must also pay an amount of tax that matches the tax withheld from the employee's wages. The employer must file an Employer's Quarterly Tax Return (Form 942) each quarter and a Wage and Tax Statement (Form W-2) at the end of the year.

In addition, an employer must pay federal unemployment taxes if he or she paid cash wages to household employees totalling $1,000 or more in a calendar quarter in the current or preceding year. The employer must file an Employer's Annual Federal Unemployment Tax Return (Form 940 or Form 940-EZ) at the end of the year.

Reasons for Simplification

Employer return requirements are confusing and burdensome for many individuals, who may be employers only because they employ a domestic employee on an intermittent basis. Streamlining the return requirements would reduce the filing burden.

Explanation of Provision

The bill changes the threshold for withholding and paying social security taxes from $50 a quarter to $300 a year. The bill requires an individual who employs only household employees to report any social security or federal unemployment tax obligation for wages paid to such employees on his or her income tax return for the year. The bill includes a household employer's social security and unemployment taxes in the estimated tax provisions. The bill authorizes the Secretary to enter into agreements with states to collect state unemployment taxes in the same manner.

Effective Date

The provision is effective for remuneration paid in calendar years beginning after December 31, 1991.

2. Penalties for failure to provide reports relating to pension payments (sec. 702 of the bill and secs. 6652(e) and 6724 of the Code)

Present Law

Any person who fails to file an information report with the Internal Revenue Service on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely (sec. 6721). A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments (sec. 6652(e)).

Reasons for Simplification

Conforming the information-reporting penalties that apply with respect to pension payments to the general information-reporting penalty structure would simplify the overall penalty structure through uniformity and provide more appropriate information-reporting penalties with respect to pension payments.

Explanation of Provision

The bill incorporates into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. Thus, information reports with respect to pension payments would be treated in a similar fashion to other information reports.

Effective Date

The provision applies to returns and statements the due date for which is after December 31, 1991.

3. Clarify that reproductions from digital images are reproductions for recordkeeping purposes (sec. 703 of the bill and sec. 6103(p) of the Code)

Present Law

Reproductions of a return, document, and certain other matters have the same legal status as the original for purposes of judicial and administrative proceedings. It is unclear whether reproductions made from digital images are also accorded the same legal status as originals.

Reasons for Simplification

Reducing the IRS' need to maintain hard-copy originals of documents would simplify the administration of the tax laws. As part of its systems modernization plan, the IRS intends to store returns, documents, and other materials in digital image format. This plan will permit the IRS to respond much more quickly to taxpayers' inquiries about the status of their accounts. It will facilitate implementation of this plan to clarify that reproductions made from such images would be accorded the same legal status as other reproductions.

Explanation of Provision

The bill provides that the term reproduction includes a reproduction from a digital image. The bill also requires the Comptroller General to conduct a study of available digital image technology for the purpose of determining the extent to which reproductions of documents stored using that technology accurately reflect the data on the original document and the appropriate period for retaining the original document.

Effective Date

The provision is effective on the date of enactment.

4. Repeal tax shelter registration requirements (sec. 704 of the bill and sec. 6111 of the Code)

Present Law

Organizers of tax shelters must register their shelters with the IRS before offering any interests for sale.

Reasons for Simplification

As a result of the passive loss provisions (and related provisions) of the Tax Reform Act of 1986, tax shelters are no longer being marketed as they were prior to that Act. Registration of tax shelters is therefore no longer necessary for the proper administration of the tax laws. Repeal of the registration requirements would reduce paperwork burdens for taxpayers and the IRS.

Explanation of Provision

The bill repeals the tax shelter registration requirements.

Effective Date

The provision is effective on the date of enactment.

5. Repeal of authority to disclose whether a prospective juror has been audited (sec. 705 of the bill and sec. 6103(h)(5) of the Code)

Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

Reasons for Simplification

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of the nature of this provision have caused confusion and, in some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.

Explanation of Provision

The bill repeals the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The provision is effective for judicial proceedings pending on, or commenced after, the date of enactment.

6. Repeal TEFRA audit rules for S corporations (sec. 706 of the bill and secs. 6037, 6241, 6242, 6243, 6244, and 6245 of the Code)

Present Law

An S corporation generally is not subject to income tax on its taxable income. Instead, it files an information return and the shareholders report their pro rata share of the S corporation's income and deductions on the shareholders' tax return.

The Subchapter S Revision Act of 1982 generally made the TEFRA partnership audit and litigation rules applicable to S corporations. These rules require the determination of all "Subchapter S items" at the corporate, rather than the shareholder, level. These rules also require a shareholder to report all Subchapter S items consistently with the corporation's information return or to notify the IRS of any inconsistency. Temporary regulations contain an exception from these rules for "small S corporations," i.e., those with five or fewer shareholders, each of whom is a natural person or an estate.

Reasons for Simplification

An S corporation generally is limited to 35 investors. In addition, the vast majority of both existing and newly formed S corporations are expected to qualify for the small S corporation exception from the unified audit and litigation provisions. Consequently, a unified audit procedure is unnecessary for S corporations.

Explanation of Provision

The bill repeals the unified audit procedures for S corporations. The bill retains, however, the requirement that shareholders report items in a manner consistent with the corporation's return.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

7. Clarify statute of limitations for items from passthrough entities (sec. 707 of the bill and sec. 6501(a) of the Code)

Present Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that present law may be unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). (Compare Fehlhaber v. Comm., 94 TC 863 (1990) with Kelly v. Comm., 877 F.2d 7567 (9th Cir. 1989)).

Reasons for Simplification

Uncertainty regarding the correct statute of limitations hinders the resolution of factual and legal issues and creates needless litigation over collateral matters.

Explanation of Provision

The bill clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

B. Tax Court Provisions

1. Clarify jurisdiction of Tax Court with respect to overpayment determinations (sec. 711 of the bill and sec. 6512(b) of the Code)

Present Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Reasons for Simplification

Clarification of the jurisdiction of the Tax Court and the appealability of orders of the Tax Court would provide for greater certainty for taxpayers and the Government in conducting cases before the Tax Court. Clarification will also reduce litigation.

Explanation of Provision

The bill clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The bill also clarifies that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The provision is effective on the date of enactment.

2. Clarify procedures for administrative cost awards (sec. 712 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating a denial of administrative costs are unclear.

Reasons for Simplification

The proper procedures for applying for a cost award are uncertain in some instances. Clarifying these procedures will decrease litigation over these procedural issues.

Explanation of Provision

The bill provides that a taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. The bill also provides that a taxpayer who seeks to appeal an IRS denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice.

The bill clarifies that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court.

Effective Date

The provision is effective on the date of enactment.

3. Clarify Tax Court jurisdiction over interest determinations (sec. 713 of the bill and sec. 7481(c) of the Code)

Present Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

Reasons for Simplification

It would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases.

Explanation of Provision

The bill provides that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The provision is effective on the date of enactment.

4. Clarify net worth requirements for awards of administrative or litigation costs (sec. 714 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Reasons for Simplification

Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return. Clarifying these rules will decrease needless litigation over procedural issues.

Explanation of Provision

The bill provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The bill also provides that individuals who file a joint tax return shall be treated as one individual for purposes of computing the net worth limitations. Consequently, the net worths of both spouses are aggregated for purposes of this computation. An exception to this rule is provided in the case of a spouse otherwise qualifying for innocent spouse relief.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

C. Permit IRS to Enter Into Cooperative Agreements With State Tax Authorities (sec. 721 of the bill and new sec. 7524 of the Code)

Present Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed (62 Comp. Gen. 323,335 (1983)).

Reasons for Simplification

Most taxpayers reside in States with an income tax and, therefore, must file both Federal and State income tax returns each year. Each return is separately prepared, with the State return often requiring information taken directly from the Federal return. Permitting the IRS to enter into agreements with States that are designed to promote efficiency through joint tax administration programs would reduce the burden on taxpayers because much of the same information could be used by both Governments.

For example, the burden on taxpayers could be significantly reduced through joint electronic filing of tax returns, whereby a taxpayer electronically transmits both Federal and State returns to one location. Joint Federal and State electronic filing could simplify and shorten return preparation time for taxpayers. Also, State governments could benefit from reduced processing costs, while the IRS could benefit from the potential increase in taxpayers who would elect to file electronically because they would be able to fulfill both their Federal and State obligations simultaneously.

Explanation of Provision

The bill provides that the Secretary is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include (1) joint filing of Federal and State income tax returns, (2) single processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

The bill provides that these agreements may require reimbursement for services provided by either party to the agreement. Any funds appropriated for tax administration may be used to carry out the responsibilities of the IRS under these agreements, and any reimbursement received under an agreement shall be credited to the amount appropriated.

No agreement may be entered into that does not provide for the protection of confidentiality of taxpayer information that is required by section 6103.

Effective Date

This provision is effective on the date of enactment.